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Comments on Markham's Net Capital Rule

Paul Uhlenhop
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My congratulations to Professor Markham on his excellent paper raising a number of important issues that need to be considered with respect to the net capital rule ("Capital Rule") of the Commodity Futures Trading Commission ("CFTC").¹ His paper is an excellent academic work and provides a sound basis for a profound discussion of the complex issues involving the CFTC's Capital Rule. I completely agree with Professor Markham that the Capital Rule needs to be revisited in a number of respects. Professor Markham does not hesitate to list the difficulties and the problems, both political and practical, with respect to changes in the Capital Rule. The purpose of this Commentary is not to criticize Professor Markham's excellent article, but rather to add my personal insights concerning reform of the Capital Rule.

Reform of the CFTC Capital Rule is not an easy task. The CFTC Capital Rule affects and is affected by many issues that complicate efforts to reform it. Numerous efforts led by United States regulators are currently under way to establish worldwide capital standards. Professor Markham notes the Basle Committee on Banking Supervision has advanced standards involving the use of risk-based capital requirements for both on- and off-balance sheet risk.² Likewise, the Securities and Exchange Commission ("SEC") and CFTC, in the Derivative Policy Group Report,³ have accepted on a trial basis the use of risk-based capital evaluations. Professor Markham aptly suggests that reformers of the Capital Rule adopt a risk-based approach;⁴ however, truly successful reform of the Capital Rule only can be achieved after reformers give careful consideration to all matters that complicate the rule's reform.

* See Jerry W. Markham, The CFTC Net Capital Rule—Should a More Risk Based Approach Be Adopted?, 71 Chi.-Kent L. Rev. 1091 (1996).
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2. See Markham, supra note *, at 1097-98.
4. See Markham, supra note *, at 1104.
One of the major problems affecting efforts to reform the Capital Rule is the existence, in today's world, of futures commission merchants ("FCMs"). Almost all FCMs of any size are also broker-dealers. As a result, FCMs are subject to both the net capital rule and reserve rule of the SEC. Reform of the CFTC's Capital Rule would require for all practical purposes the SEC's concurrence and consent because the CFTC's Capital Rule incorporates large parts of the SEC capital rule and the SEC capital rule, by reason of its Appendix B, incorporates large parts of the CFTC Capital Rule. The two agencies have worked long and hard to coordinate their respective capital rules, attempting to iron out inconsistencies. However, despite this coordination, gaps and problems still remain.

Other important problems to reform efforts are the ever increasing impact of banks expanding into all financial services, and the globalization of financial services. Today many banks or their holding companies own FCMs and broker-dealers. Bank regulatory authorities impose capital requirements in addition to the capital requirements of the SEC and the CFTC. Furthermore, the business of today's futures industry is worldwide. Today many FCMs operate in various countries throughout the world, sometimes through separate subsidiaries, but at other times through branches not incorporated in the particular jurisdiction. Thus, a financial services entity may be subject to the conflicting capital rules of various domestic and foreign regulators. Due to these problems, attempting to comply with various conflicting capital requirements is a difficult, if not impossible, job. Consequently, reformers of the CFTC Capital Rule should take into consideration the rule's affect on the applicable capital rules of major world financial centers, as well as those of the SEC and of the banking regulators.

Any revision of the CFTC Capital Rule also must include, as Professor Markham remarks, an examination of segregation requirements. The segregation requirements under the CFTC's rules assume that funds and securities deposited in a quasi-trust with certain qualified financial institutions will always be there. As shown by the Barings Bank fiasco, this assumption may be entirely wrong, not

5. See 17 C.F.R. § 240.15(c)3-1 (1996).
7. See e.g., 17 C.F.R. § 1.17(c)(5)(vii) (1996).
8. See 17 C.F.R. § 240.15(c)3-1b (1996).
9. See Markham, supra note *, at 1100.
only in foreign countries, but also in the United States as well. In the event of a bank’s failure, segregated funds and securities of FCM customers may be in jeopardy. Thus, such funds or securities should not be available for general creditors. Reform of the Capital Rule, consequently, should encourage legislation protecting funds and securities held in segregation by banks for customers of other domestic and foreign financial institutions.

Professor Markham’s remarks about the disincentive, under the Capital Rule, for an FCM to hold customer funds is also a point of concern that regulators should address. Under the current Capital Rule an FCM holding customer funds and securities increases its capital requirement. Thus, the CFTC’s Capital Rule certainly gives an FCM incentive to return customer funds in excess of minimum margin requirements—by holding customer funds, the amount in segregation increases, correspondingly increasing an FCM’s capital requirements. One might argue that, for customer protection, the less customer funds passing through the hands of an FCM, the better. But if a large customer defaults and the FCM’s capital is not adequate, other FCM customers may suffer.

Professor Markham’s suggestions concerning this problem are worthy of further consideration, but face certain practical problems. Professor Markham suggests a more risk-based capital rule founded on minimum margin requirements for both customer and proprietary accounts. Under this proposal, FCMs would be required to set aside a percentage of the contract-market minimum margin requirements as a reserve for meeting customer deficits. Since margins are set using a sophisticated risk-based analysis, this proposal would relate capital to risk. Furthermore, the percentage of the margin would be based on the volatility of specific positions. The reserve requirement would be reduced on an individual account basis by excess customer funds, and increased by a charge for concentration positions. Additionally, under Professor Markham’s proposal, a certain percentage of excess customer funds and securities in segregation could be used to meet minimum capital requirements.

Such a rule, on its face, would eliminate the built-in disincentive for an FCM to urge its customers to withdraw excess funds. Thus, the rule would force an FCM either to put its own capital at risk for the

12. See Markham, supra note *, at 1103.
14. See Markham, supra note *, at 1106.
customer-margin reserve, or induce customers to leave excess funds with it. I doubt, however, based on personal experience, that either institutions or sophisticated customers would willingly maintain excess funds at an FCM. First of all, some entities, like investment companies registered under the Investment Company Act of 1940, are not allowed under their governing statutes to keep their excess funds with an FCM. Additionally, competitive pressures being what they are and the market being a largely institutional one lead me to believe that most institutions would not keep excess funds with an FCM. Many institutions today keep no funds with an FCM above the absolute minimum margin requirement, rather they move any gain or loss in or out of their account each day by wire transfer. Also, Professor Markham’s approach is problematic because this change in the Capital Rule would give a significant competitive advantage to large, well-capitalized firms. Unless small, less-capitalized firms could induce customers to leave excess funds with them, they would be, for all practical purposes, frozen out of the market. Finally, this proposal would probably significantly increase entry barriers to the clearing and carrying of customer accounts, particularly institutional accounts, which are a very large part of today’s market.

Professor Markham also considers other risk-based alternatives. Value-at-risk ("VAR"), a device for measuring net capital requirements, is one such alternative. While the financial services industry initially has accepted VAR, it is probably too early to accept it across the board for capital purposes due to the reasons Professor Markham notes in his article. Another alternative, which appears to be an excellent system for managing risk, is the Standard Portfolio Analysis of Risk Performance Bond System ("SPAN"). As noted by Professor Markham, the SPAN system was developed by the Chicago Mercan-

16. See Markham, supra note *, at 1104-08. Currently, the Capital Rule requires an FCM's minimum net capital to be four percent of its segregation amount. See 17 C.F.R. § 1.17(a)(1)(i)(B) (1996). The CFTC probably did not arbitrarily set this four percent requirement. As a historical footnote, it is my understanding that the CFTC's minimum net capital requirement of four percent of segregated funds evolved from a survey of clearing firms, including members of the Chicago Board of Trade and of other exchanges, at the time the CFTC Capital Rule was under consideration as a proposed rule. This survey was undertaken by an outside, independent public accounting firm to determine the percentage relationship of segregated funds to capital at the major clearing firms. The four percent amount was approximately one-half the amount of capital at FCM's which were considered well capitalized.
17. Value-at-risk is a measuring device that estimates the "maximum potential loss from assets or derivative positions held by a firm over a given period of time." Markham, supra note *, at 1107 (citation omitted).
18. See id.
tile Exchange, and is used by futures exchanges to compute risk levels in setting margin requirements.\textsuperscript{19} Currently, other similar systems are starting to be used for setting margins.

In summary, the answer to Professor Markham's question, "Should a More Risk Based Approach Be Adopted?" is an unqualified "yes." How to do it is the more difficult issue. Professor Markham's thought-provoking article presents a long overdue discussion of issues involving the CFTC's Capital Rule that deserve further attention.

\textsuperscript{19} See \textit{id.} at 1105 n.72.