SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

GEORGE J. BENSTON
Emory University

MARSHALL E. BLUME
University of Pennsylvania

CHARLES CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

SCOTT E. HARRINGTON
University of Pennsylvania

JOHN HAWKE
Arnold and Porter

PAUL M. HORVITZ
University of Houston

EDWARD J. KANE
Boston College

KENNETH LEHN
University of Pittsburgh

ROBERT E. LITAN
Brookings Institute and
Kauffman Foundation

HAL S. SCOTT
Harvard Law School

KENNETH E. SCOTT
Stanford Law School

PETER J. WALLISON
American Enterprise Institute

An independent committee
sponsored by the
American Enterprise Institute

http://www.aei.org

Statement No. 227

For Information Contact:

Kenneth Lehn
412-648-2034

George J. Benston
404-727-7831

Statement of the Shadow Financial Regulatory Committee

Margin Regulations

February 13, 2006

The evolution of equity-based financial products during the past few decades has revealed fundamental problems in government regulation of margin requirements in U.S. securities and futures markets. An immediate issue that requires Securities and Exchange Commission (SEC) action is its current regulation of margin requirements on two instruments: (1) equity options and (2) single-stock futures (SSFs), for which it shares regulatory authority with the Commodities Futures Trading Commission (CFTC). The Shadow Financial Regulatory Committee urges the SEC to allow options and futures exchanges to oversee margin requirements on these products without regulatory interference.

The SEC and CFTC currently disagree about how to regulate SSFs. The controversy reflects differences in the role that margin requirements play in derivatives and equity markets. In futures markets, margin requirements act as a performance bond and are regulated by futures exchanges through their clearinghouses. In securities markets, margin requirements are simply a government instrument assigned to the Federal Reserve and the SEC. Congress

saw margin requirements on equity transactions as a way to protect investors and the stock market from "excessive" leverage and "excessive" speculation.

The CFTC and many in Congress favor changing the regulation of margin requirements on SSFs. They advocate shifting this regulation to the futures exchanges and allowing the exchanges to use portfolio margining. In portfolio margining, which is used generally in the futures industry, futures clearinghouses establish margin requirements based on protecting counterparties against economic losses that an investor's portfolio (as opposed to a specific security or futures contract) is likely to incur on a daily basis.

An impediment to this desirable change is the Commodity Futures Modernization Act of 2000, which authorizes the trading of SSFs and mandates that margin requirements on SSFs, over which the SEC and CFTC share jurisdiction, should be comparable to the corresponding margin requirements on equivalent equity options positions. Consequently, since their inception SSFs have been subject to a 20% margin requirement, because this is equivalent to existing margin requirements on equity options. The growth of the U.S. market for SSFs has been constrained, in part, because of the relatively onerous U.S. margin requirement. Since the law requires that both SSFs and equity options be treated comparably, the Committee believes that both should be treated as the CFTC treats SSFs, allowing margin requirements to be set by the exchanges rather than by regulators.

More generally, the Committee questions whether *any* government regulation of margin requirements in financial markets, including Regulation T, is necessary. In our opinion, it is not appropriate to view margin requirements as a policy lever to curb "excess" speculation in financial markets. Nor are such requirements useful for protecting the financial system from the risk of systemic failure. At a minimum, we urge the Federal Reserve System, Treasury, SEC, and CFTC to undertake a study of margin regulation in U.S. financial markets to determine if there is a principled empirical basis for any continued government regulation of margin policy.