Prepared Remarks of Anthony J. Leitner
to the
Commodity Futures Trading Commission and the Securities & Exchange Commission
at a joint meeting, September 2, 2009

Chairman Schapiro, Chairman Gensler and distinguished Commissioners, my name is Tony Leitner.

I am honored to have been invited to participate in this historic joint meeting. For the past 30 years, I have worked with the staffs of your Commissions and with many individual Commissioners on a variety of issues, including several significant legislative and rule-making efforts. I have represented a major investment bank as a senior lawyer as well as securities, futures and derivatives industry groups. Much of my work has dealt with operations, capital, margin and clearing issues – the "plumbing"of our financial system.

Therefore I will address my remarks to one important area in the clearance and margin area that is past due for harmonization – and unfinished business for me: portfolio margining and, in that context, cross margining.

Portfolio margining, or "risk-based margining," sets margin requirements for an account containing financial investments based on the greatest projected net loss for all positions in the account, using some form of computer modeling to perform risk analysis.

Cross-margining is a portfolio margining system that encompasses both futures products regulated by the CFTC as well as SEC-regulated securities products.

The simplest example would be a customer who wishes to finance the purchase of an Exchange Traded Fund replicating a securities index such as the S&P 500 stock index where the customer also wants to hedge all or a part of its exposure by selling an S&P index futures contract. Another example would be a customer that sells Treasury securities short and hedges by buying a similar maturity Treasury bond futures contract. A more complicated example is a customer that owns a portfolio of stocks and is also short a portfolio of stock of relatively similar value and is also long or short a portfolio of options and stock index futures. In all these cases, a risk model would be used to analyze the risk of maximum loss in the portfolio unlike existing rules that apply strategy-based or haircut based requirements.

Why is it important to tackle this problem now?

Large, sophisticated investors in the financial markets, such as hedge funds, employ leverage to enhance returns and also use a variety of instruments to take positions, modify their risk profile or to hedge these investments. These firms seek opportunities to execute and carry these positions at the lowest cost and in the most efficient manner. For example, firms want the ability to be able to view all their positions in a single account, and may choose an intermediary (commonly known as a “prime broker”) to clear these positions who can provide this service while providing the best financing terms. Often, the best financing terms and most efficient use of capital is achieved in a portfolio margining context that will take into account the underlying asset regardless of the nature of the instrument that the firm is long or short. These would include both exchange-traded (or listed) instruments, including futures, and OTC derivatives such as swaps and OTC options.

In spite of regulatory reforms in the United States, barriers still exist that prevent a U.S.-based intermediary from providing the sort of comprehensive portfolio margining service that these firms want. For many years the only recourse was to find a firm to act as a prime broker in London where the legal regime had few if any impediments for a prime broker to provide the comprehensive portfolio margining and cross margining sought by these investors.

But, as the demise of Lehman Brothers has demonstrated, investors who dealt with Lehman’s London affiliate took on substantial risks in the event of the insolvency of their prime broker. Many are still waiting for return of their assets.

I contend, therefore, that the establishment of a comprehensive, well regulated regime that permits comprehensive portfolio margining at the clearing firm level is a critical customer protection issue.

Where are we today?

While the securities regulators have taken steps to allow broker-dealers to establish a portfolio margin account, the instruments that can be included in the account are, as a practical matter, limited to equity securities and related options. And although the regulations technically permit the inclusion of certain index futures in the calculation, impediments under the Commodity Exchange Act and CFTC rules preclude the inclusion of these products in the account. As a result, customers who use futures to hedge risk in their securities positions do not get the full benefit of portfolio margining and at worst might have to post futures margin and mark-to-market payments separately while having to maintain equity in the broker-dealer at Reg. T and maintenance margin levels.

Ideally, the most efficient use of capital is achieved not only by portfolio margining at the prime broker level, but also at the clearinghouse level. As I pointed out in supplemental material provided for these hearings, portfolio and cross margining exists at both the clearing firm and clearinghouse levels for a narrow group of professional traders. So we have systems in place that have worked well, but no regulatory framework under which to expand the benefits of this system to additional users.

The problem – at least for cross-margining - lies in the disparate customer protection regimes applicable to securities broker-dealers on the one hand and FCMs on the other.

What are the solutions?

Two approaches have been advanced regarding how cross margining can be structured. One approach has become known as the "one pot model". It contemplates that there would be a single account at the firm level (that is, an account on the books of a prime broker), and, at the clearing level, a set of agreements between the futures and options clearing houses that allow the prime broker's paired cross-margining accounts at the futures clearinghouse and at the securities clearing house to be margined *as if* they were a single account, with collateral for the account held jointly by the two clearinghouses. This model is based on the structure (at least from the operations point of view) that is used today for firms that clear and margin options market makers.

The second approach has been called the "two pot model" and, as I understand it, is based – at the clearing firm level – on maintenance of a fully-margined futures account that guarantees the customer's security account and – for purposes of the portfolio margin rules in the securities account – is allowed in the margin calculation. At the clearinghouse level, the two pot model is based on unsecured cross-guarantees between the two clearinghouses with no common pool of collateral. Even the proponents of a two-pot model generally concede that the one-pot model is a more efficient and more complete form of cross-margining, but favor the two-pot model from the pragmatic perspective that it allegedly does not require harmonization between the SEC and the CFTC customer protection regimes, which many have perceived as unachieveable for political reasons.

Having been personally involved on behalf of both the securities and futures industries on this matter for many years, I appreciate the difficulties involved in attempting to reconcile the differences in the regulatory approaches of the Commodity Exchange Act and the Federal Securities Laws, particularly in the area of protection of customer funds and positions used to collateralize market exposures.

Is there a process to resolve the impasse?

My personal opinion is that the fastest "time to market" to permit cross margining at the clearing firm level is for the agencies to agree to take the steps necessary to implement one, preferably both, of the following alternatives.

1. Use the existing portfolio margin framework adopted by the securities regulators. The CFTC would use its exemptive power to allow customers of a dual registrant to waive CEA segregation and maintain futures positions in the securities portfolio margin account. If the CFTC concluded that it does not have that authority, the Commission would seek statutory changes to permit it to do so. This approach might also require minor amendments to the Securities Investor Protection Act to allow futures products to be treated like securities options when, and only when, they are carried in securities accounts pursuant to an SEC-approved cross-margining program.

2. Allow a broader range of customers of a dual registrant to establish clearing accounts under the current model used today by market professionals. This would involve, at the very least, the SEC's willingness to expand the categories of investors

eligible for this scheme, which treats cross-margining accounts as futures accounts. This alternative may be more suitable for customers whose cross-margining activity is limited to securities options vs. futures and does not including financing of underlying equity securities, which is likely to be unworkable in a futures account for both legal and systems reasons.

Separately, the Commissions could begin consultations immediately – and jointly - with the relevant stakeholders: financial firms, clearinghouses, exchanges and the best legal minds to review other alternatives that would achieve an even more comprehensive portfolio margin structure - one that would include more asset classes and achieve greater efficiencies at the clearinghouse level.

The consultation modality could be either a jointly organized advisory committee or by means of an ad-hoc industry-sponsored group that would be tasked with recommending a viable solution (a model I proposed to in the past). The industry-led consultative approach is similar to the industry group that worked with your respective agency's staffs during the SEC/CFTC securities futures joint rulemaking process.

I believe it would be helpful to such a consultative process if the Commissions agreed upon – or asked the consultative group to agree upon – principles that would guide the analysis of models. These could include the following:

- The system for aggregating futures and securities positions at the firm level for margin calculation purposes should be feasible with existing technology and systems, or with modifications to such systems achievable in a reasonable time and at a reasonable cost;
- The firm should be able to include a broad range of asset classes in a portfolio margin account – including OTC derivatives and newly cleared products such as swaps in the portfolio margin calculation;
- There should be legal certainty for the regime protecting the assets of portfolio margin customers assets held by the clearing firm in the event of a firm insolvency that does not denigrate the current rights or priorities of other customers and facilitates either the prompt liquidation or transfer of positions;
- Margining a clearing firm's positions for portfolio margin customers offsetting positions between clearinghouses should be efficient and secure;
- There should be legal certainty with respect to the rights of the clearinghouses to margin held in each clearing system and in any shared collateral pool.

In addition to considering alternatives to the structures I proposed, there is a third approach that may be worthy of further study:

Create a new class of "clearing only" firm based on the precedent of the "OTC derivatives dealer" or "limited purpose" broker-dealer. This would be a separate legal entity jointly regulated by the SEC and the CFTC that is not required to be a member of a securities SRO and performs only clearing and financing services. Transactions would have to be executed in a broker-dealer or FCM and be given up for clearing and margining purposes to this entity. It would then provide financing on a portfolio margin and cross-margin basis. This entity would be subject to agreed upon capital requirements, required customer equity (and capital charges in lieu thereof), permitted risk management models, risk management and internal controls, any limitations on collateral management and any limitations on customers eligible to use the services of such an entity. An advantage of this approach is that it is potentially scalable to include products not currently permitted to be included in a broker-dealer portfolio margin account.

The disadvantage of this model is that it would probably require legislation to establish a stand-alone insolvency regime for such an entity and to authorize the Commissions to implement the model and jointly regulate it.

The consultative group would also be expected to make proposals for amendments to relevant statutes as well as agency or exchange rulemaking that may be necessary to implement whatever model they recommend.

In conclusion, let me again stress the importance of addressing this issue.

It is coming up to 10 years since the Fed took the necessary action to allow regulators to approve portfolio margin outside of Regulation T. That initiative, which itself took several years to accomplish, was in response to the industry's concern that the business of providing leverage to clients in a rational way was going to London where there were no legal limitations on portfolio margin or cross margin. As a result of the failure to create a well regulated framework with similar flexibility in the U.S., billions of dollars of financing has been provided in other financial centers. The demise of Lehman Brothers demonstrated the risks to U.S. investors of sending their business abroad.

Finding a solution that allows for comprehensive portfolio and efficient cross-margining at both the clearing firm and clearinghouse levels in this country is the best way to avoid such debacles in the future. That does not preclude shorter term pragmatic approaches that expand the ability of firms to provide cross margining in a limited context now.

Like many difficult problems, the right answers are often found by getting the right people in the room. Many of them are appearing before you today. Let's get started.

Thank you again for the opportunity to express my views on this issue.