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Margin Rule Changes Warrant Systems Enhancements

NEW YORK — The US **Securities and Exchange Commission**'s rule change release number 34-54125 on portfolio margining rules, in effect on a pilot basis from July 11, 2006 through July 31, 2007, will require investment management firms to integrate characteristics of different financial instruments in their systems. This SEC portfolio margining initiative aims to set margins for investment portfolios to provide US markets with risk-based margin rules that will create advantages for US markets and investors. The initiative applies to **New York Stock Exchange** (NYSE) participating brokers and eligible investors.

"The SEC is trying to level the playing field with Europe. Its pilot program makes security futures and listed single-stock options eligible for portfolio margining.

The portfolio margining rules had been largely unchanged since the Securities Acts of the 1930s, observes Steven Goldberg, Principal at **Grant Thornton LLP**, a US unit of Grant Thornton International, an accounting, tax and business consultancy. "The SEC is trying to level the playing field with Europe and really bring the margin requirements up to today's investing characteristics, in which large investors have positions hedged across different instruments, so all the margin requirements shouldn't be the same," he says. Large sell-side institutions have for many years moved funds offshore, largely to Europe, to attract hedge fund investments by offering higher portfolio margining leverage, adds Goldberg. "It's not a big change other than being able to keep the money in the US and still offer increased leverage," he says, noting that the percentage possible to margin could rise from 50 percent of a portfolio to as high as 80 percent.

The pilot program adds security futures products and listed single-stock options to the instruments eligible for portfolio margining. The rule changes being tested through the pilot program also waive the $5 million equity minimum requirement for customers that are not broker-dealers or members of a national futures exchange. The SEC's 34-54125 release defining the pilot program issued July 11 (which itself was an update of previously issues releases on the portfolio margining issue) also allowed the use of a single portfolio margin account for all eligible products.

Along with changes to systems, operations and infrastructure, firms will have to develop and use new policies and procedures for their portfolio margining.

Previously, margining leverage of different financial instruments was computed separately by type of instrument. "With the new rule, for an investor trading derivatives, options, fixed-income and equities, based on the risk characteristics of their portfolio, the firm has to run it through leverage calculations and determine whether the investor is approved for a margin account, and how much of the account the investor can actually leverage," says Goldberg.

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The pilot program also requires firm to monitor risk in portfolio margin accounting through a defined risk analysis methodology, specifying computations to be made, frequency of these computations, records to be reviewed and maintained, and who will be responsible for these functions. Going beyond the pilot program's requirements to be competitive at attracting hedge fund business will add substantial costs. "Firms will have to demonstrate they have proper policies and procedures documented and in place just to support this new leveraging model," says Goldberg. "At very least, they need to integrate the software and may have to modify other operational and technical systems to support the integration of these instruments in the margin calculations." ❑