Margins:
Much Discussed,
Little Understood

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If this seminar on speculation had been held a few years ago—or perhaps even a year ago—I'd personally have been a lot more comfortable. A lot more comfortable because I'd probably have been seated on that side of the speaker's table instead of standing on this side.

I strongly suspect the subject of margins wouldn't even have been on your program a year or two ago.

Other than for a speculator who just watched his long corn go limit down or his short soybeans go limit up, no one gave much thought to margins. Or to what they are, or what they do, or why we have them.

A few years ago, in fact, our clearing corporation considered preparing a little booklet to explain margins. It never got published. The reaction to the idea ranged from an "ugh" to a "why?" The consensus was that margins are arcane, margins are dull, and, besides, who really cares?

That I am on this side of the speaker's table, that margins are on your program today, is one indication that the situation has rather suddenly changed.

Commodity margins have suddenly become interesting.

All at once, it seems that just about everyone cares.

Market participants care.

Newspaper and TV commentators care. Including those who'd barely even heard of futures markets until the day before yesterday. Government regulators care because there is no greater anathema than that which can be regulated but isn't.

Additionally, of course, there are all manner of congressional crisis chasers. They, too, express care.

To try to put the subject in perspective—and before getting into the implications of it—I think it's useful to examine why the sudden interest in margins. Mainly, and briefly, it seems to me that there are two reasons.

The first, which requires no elaboration, is the kinds of markets we've had in the past year. And, in the case of silver, the much-publicized adventures and misadventures of certain market participants, particularly as their problems had to do with margin calls. High volume, highly volatile markets inevitably attract attention. And criticism. The unknown worries people. And to most people, futures markets and the mechanics of how they work are an unknown.

A second reason for the sudden interest in margins, it seems to me, is the development and rapid growth of financial futures trading. For well over a century, we've had trading in agricultural and other nonfinancial commodities. And I think it's fair to say we have a pretty good understanding, at least in the agricultural community, of how these markets work and of the time-proven fact that they do work.
But with financial futures, we're in a whole new ballgame. With, for the most part, all new players. And, unfortunately, a lot of jurisdictional squabbling among would-be referees. As a result, in the case of financial futures, we don't have a century of market understanding. And we don't have a century of market confidence.

When you put the newness and fast growth of financial futures in the same time frame with something like the silver situation, I don't think it's too surprising that suddenly there's all kinds of interest in margins. And in whether government should become more involved in regulating margins. It's regrettable, in this context, that interest increases almost always faster than knowledge. Or to put it more bluntly, it's a shame there are so many people discussing commodity margins who don't seem to have the slightest understanding of commodity margins.

At the low end of the understanding scale, it's not at all unusual to hear someone say something like, "You can't buy common stocks with only a 5 percent down payment, so why should you be able to buy futures contracts with only a 5 percent down payment?" I hardly need to explain to an audience such as this that commodity futures margins aren't down payments. And that, notwithstanding the same name, they are in no way even a third cousin to stock margins, which are solely a credit restriction. But the very fact that confusion exists gives you some idea of what we're up against in dealing with people who would tinker with commodity margins without even understanding what they are.

Moreover, since the subject of this seminar is speculation, I think it is useful to recognize just what it is that these tinkerers have in mind when they launch trial balloons like suggesting a fivefold or a tenfold increase in commodity margin requirements, and then whisper quietly that maybe bona fide hedging margins could be treated differently.

What they have in mind, quite simply, is "curbing" speculation. And I put the word curbing in quotes, because it's their euphemism, not mine. When most of these would-be tinkerers look at speculation and at speculators, it can be stated flatly that they see no white hats! What they do see is a business—a marketplace—with very low margins that translate into a tremendous amount of leverage. They see that as little as $1,000 up front can buy or sell $40,000 worth of soybeans. Or $100,000 worth of Treasury bonds. Frankly, this worries the hell out of them.

It worries them because they perceive that speculators, utilizing this leverage, are up to no good. And it worries them, perhaps even more, that such small margins may be inadequate to assure the financial integrity of the market and its contracts. Financial integrity meaning safety.

Since others on your seminar program will undoubtedly address the role, the necessity, the benefits of speculative participation in a viable futures market, I intend to focus my comments on the second area of concern: the area of margins and contract integrity.

In this regard, a little history might be useful.
If one were to assume that margins are as old as futures trading, one would be mistaken. In fact, the absence of margins—of any type of money up front—is a reason futures trading in its early years wasn’t particularly successful. If market prices, come delivery month, were lower than contract prices, buyers often defaulted. And if market prices were higher, sellers often defaulted.

It rather quickly became evident that a marketplace couldn’t function on “maybes.” There had to be some mechanism to provide contract integrity. What evolved was a system whereby every buyer of a futures contract and every seller of a futures contract were required at the outset to post what amounted to performance bonds. Enough “good faith” money held by a neutral party to protect the buyer against loss if prices went up and to protect the seller if prices went down.

Moreover, since market prices, then as now, were subject to change, there had to be some way for the performance bond to be increased or decreased accordingly. That is, if prices went down, the buyer of the futures contract had to come up with more money—a larger performance bond—for the protection of the seller. And vice versa if prices went up.

It was a system that worked reasonably well. But by the early 1920’s, it became evident that something more was needed. What was needed was a more formalized, a more institutional, approach to the establishment, the collection and the disbursement of the performance bond money which had come to be called margin.

This need was met in 1925 and after a great deal of debate, by the creation of the first central, exchange-affiliated clearing organization: the Board of Trade Clearing Corporation.

So much for history. Suffice it to say that although the way we do things has become a lot more sophisticated over the years, what we do, our primary function, hasn’t really changed. It’s to assure, to guarantee, the financial integrity of every futures contract bought and sold on the Chicago Board of Trade.

A measure of our success—of which we are understandably proud—is the fact that, in the 54 years since the establishment of the Board of Trade Clearing Corporation, no customer has ever lost a dime to a default on a Chicago Board of Trade contract. And we don’t intend that any ever will!

It is a system that works. It has worked and worked well through some of the most hectic and volatile markets in modern history, including periods of record limit moves in such commodities as soybeans and wheat. And including, I might point out, throughout the recent roller-coaster ride of silver prices.

To understand how the system works—and why it works—it is necessary to understand the role of the Clearing Corporation, and the process known as daily “marking to the market.” And most important of all, daily cash settlements. At center core of the system is the requirement, the absolutely unbending requirement, that the value of each open futures contract be marked to the market each day and that all gains and all losses be settled, fully, that same day. Not two days later, not seven days later, but that day. It matters not
whether the amount is $5,000 or $5 million or $50 million. Those who incur market losses must come up with the money—all of it—that day. The money is simultaneously credited to the accounts of market participants who have realized gains.

This is where the Clearing Corporation and margins come into the picture. Since it is the obligation of the Clearing Corporation to guarantee the collection of losses and disbursement of gains on a daily basis—and since I can assure you we are neither a philanthropic nor a risk-taking institution—it is our responsibility to have sufficient money for this purpose. At all time. In the bank and available.

Before getting into the nomenclature and fine points of margins, let me try to paint a broad-brush picture of how it works because the basic concept is really quite simple.

Say you and the person seated to your left enter in a futures contract. Each of you at the time you make the trade must come up with, say, $2,000: the performance bond—the good faith money—that we call margin.

On any day that the price of the commodity moves in your direction and against your neighbor, money is taken out of his or her account and immediately credited to your account. Or vice versa. This is what we mean by daily cash settlements.

Obviously, any time market losses result in reducing the money in your account or in your neighbor’s account below a level considered to be adequate, you or he or she will be called on to come up with more money. That is, more margin. So that at all times there’s enough money on deposit to immediately pay whoever realizes gains.

Now to go back and fill in the names: the amount of money—the margin—that you and your neighbor each had to come up with initially is called, appropriately, initial margin. The amount each of you must maintain in your account and below which will result in your getting a call for additional margin is known as maintenance margin.

At any time that losses reduce the funds in your account below the maintenance level, you’ll receive a call for variation margin, that is, for enough additional money to restore your account to the level of the initial margin deposit. So that as funds are taken out, more funds are promptly put in.

As I said by way of preface, that’s broad-brush. The mechanics as you might expect are somewhat more involved.

For one thing, as the clearing organization for the Chicago Board of Trade, we have no direct relationship with individual traders. Our relationship is solely with brokerage firms which are members of the Board of Trade Clearing Corporation. Every firm doing business in futures must be a clearing member or must clear its trades through a clearing member. It is these member firms that we look to for adequate margin. They in turn, look to their customers for adequate margin. Which brings me to as good a place as any to answer the question: who sets margin requirements? Who, specifically, decides that the
margin for a particular contract at a particular time shall be $1,000, or $1,500, or $5,000.

The answer is that clearing margins—those that apply to member firms of the Clearing Corporation—are established by the Clearing Corporation. By our Board of Governors. In this connection, I should note that we make no distinction between types of trades. There is not one level of margin for speculators, another for hedgers, and another for spreaders and arbitragers. The clearing margin is the same for everyone.

Customer margins, on the other hand, are set by the exchanges and by the individual brokerage firms. The exchanges set minimum customer margins for various kinds of market participants—speculators, hedgers, spreaders, etc.—and the brokerage firms can, if they wish, require even higher margins. It's not at all uncommon for a clearing margin requirement to be, say, $1,000 and for the initial customer margin for the same contract to be $1,500 or $2,000. I point this out because I hope you are going to ask why and because the answer should provide an insight into how margins are set.

At the Clearing Corporation, as I've already mentioned, our relationship is solely with clearing member firms—at the present time, a total of 144 such firms, some of which are household names and some of which aren't. To become and remain a clearing member, a firm must meet or exceed certain extremely rigid capital requirements—requirements established and enforced not just by us but by the CFTC. The firms must follow prescribed accounting and reporting practices and are subject to both routine and spot audits. The point being that we continuously monitor and assure the financial ability of clearing member firms to meet variation margin calls promptly and in full.

In addition to knowing at all times that our member firms can meet variation margin calls promptly, we have a rather highly effective way of ensuring that they do. Simply put: no pay, no trade. Any firm that hasn't fully margined its positions by 8 a.m. the next trading day won't be trading that day for the simple reason that we won't clear its trades! Additionally, we have the authority to declare its open positions in default and to sell them out in the market.

In this connection, the largest variation margin call in the history of the Clearing Corporation occurred just a few weeks ago. A single member firm, which happened to be hedging a large position in the cash market, had until the next morning to come up with $53 million. And it did, as has every member firm we've ever issued a margin call to for the past 54 years!

Most variation margin calls are issued following the close of trading based on the change in the member firm's net positions and on the change in settlement price between that day and the previous day. But a variation margin call can come at any time. We've even made variation calls based on price changes at the opening and the firm has one hour in which to meet the call.

The fact that we know our member firms can and will meet variation calls promptly is obviously an important consideration in deciding how high we need to set our margin requirements. Assurance of performance permits a smaller performance bond which, as I've pointed out, is what margin is.
In contrast, a brokerage firm may do business with thousands or tens of thousands of individual traders. And while it should certainly have enough knowledge of its customers' finances to assure solvency, it's obviously in no way comparable to the information a clearinghouse has at all times about its member firms. Neither, in most cases, does a brokerage firm have a comparable level of assurance that each and every one of its customers can and will meet variation margin calls on a same-day basis, which is a main reason initial customer margins set by exchanges and brokerage firms are frequently higher than clearing member margins. Or, to put it another way, a brokerage firm sets customer margins high enough to assure that it will have adequate, available funds to promptly meet its margin obligations, that is, its clearing margins.

Getting back, for just a moment, to the question posed earlier: why is the margin, the clearing margin, for a particular futures contract at a particular time set at, say, $1,000? Instead of $1,500. Or instead of $5,000. I can answer the question of how high we, the Clearing Corporation, set clearing member margins in six words: “High enough to assure contract integrity.” Period! That high and no higher!

Anyone who might wonder whether we occasionally err and set them lower than that should bear in mind that when the Clearing Corporation clears a trade, it becomes, in the fullest legal sense, a party to that trade. We accept the full risk, the full responsibility, of guaranteeing that trade against default. If there were to be loss due to default, if there were to be inadequate margin, it would be our loss.

Since the market value of futures contracts open at any one time can run in the tens of billions of dollars, I can assure you that the obligation to set margins high enough to prevent defaults is a responsibility that we take very, very seriously.

Specifically, what do we take into account in establishing margins? One of the considerations, I've already pointed out, is the financial ability of our clearing members to provide additional variation margin at any time and in any amount that we call for it. Daily price limits—limits on how much a given contract can change, up or down, in price during a given day—are obviously another consideration. Limit price changes represent the maximum margin account debit for that day.

Market volatility is another consideration. In a low-volatility market, we may decide that margin equal to less than day's limit price move is fully adequate. In a high-volatility market, we may demand more than a day's limit price move. Still another consideration at times is how the current market participants are, and their positions. This information is immediately available on a confidential need-to-know basis to the president and the governors of the Clearing Corporation.

If all of these various considerations and others were somehow assigned mathematical values and programmed into a computer to come up with the "ideal margin" it wouldn't work. Setting margins high enough to assure contract integrity but no higher is a judgment call.
Implicit in this explanation, I hope, is the fact that a margin level appropriate for today may or may not be appropriate tomorrow. One of the main and, indeed, crucial benefits of our margin setting capability is our ability to react to changing market conditions—rapidly and decisively. To increase or decrease margins whenever there is a need to, even when the need is immediate.

Generally not realized but worth pointing out is that there are times when we may require an individual firm, or a number of firms, to come up with more than the established clearing margin for a particular commodity at a particular time. We call this “super margin.” A variety of possible factors can lead us to say to a certain firm that in order for us to clear and guarantee your contracts, we require additional margin, in effect, a bigger performance bond. That’s not a frequent occurrence, but it can and does happen.

If I can digress for about one minute before concluding my remarks this afternoon, I’d like to get back to the subject of variation margins and, specifically, the daily settlement prices on which variation margin calls are based. In the past few months, there have been rumblings that indicate some of the same people who would have government tinker with the procedures and responsibility for margin setting would also have government tinker with settlement prices. The situations are analogous in that they both stem from misunderstanding.

As I mentioned earlier, variation margin calls reflect a change in settlement price from one day to the next and/or a change in the firm’s net positions, so, where and how settlement prices are established obviously affects the size of variation margin calls. Settlement prices are established, after the close of trading, by the Clearing Corporation. They are generally that day’s closing price or, if prices close in a range, a price that we consider indicative of the market at the close. Without going into all of the considerations involved in establishing a specific settlement price or the dangers of trying to set it by some hard, fixed formula, it needs to be said that there is one, and only one, bottom-line consideration consistent with the Clearing Corporation’s obligations: that is the price at which we are willing to accept for clearing and thereby guarantee the contract. While the settlement price may be looked to by some as a benchmark for estimating a commodity’s cash market value, this is not its purpose.

An entire speech could be directed at this, but that is not my purpose. I do want to make the point, though, that regulatory meddling in settlement prices would be totally inappropriate and financially dangerous, as would regulatory meddling in any aspect of margins. Government is not well suited—either by its skills or by its motives—for margin-setting responsibility. Those who know not what they do ought not to be given the job of doing it.

More, much more could obviously be said on the subject of margins. And in the appropriate forum in the weeks and months ahead, much more should be said. Because, and I say this without the slightest exaggeration, properly set margins make futures markets work.

Improperly set margins, margins set too low or too high, margins adjusted too slowly, or margins manipulated by a bureaucracy for political or other self-serving purposes could cause futures markets to stop working. Could, and
almost certainly would. It is a subject, I suggest, that deserves your most carefully considered attention.
Discussion

Terry Martell: Do the clearing members of the Board of Trade Clearing Corporation have limited or unlimited liability with regard to a default?

Walter Brinkman: They have liability limited to their stock holdings in the Clearing Corporation.

Terry Martell: What stands behind a major catastrophe of some nature? Let’s say that this $53,000,000 margin call was not made and the trust fund of $53,000,000 was exhausted. Then what happens?

Walter Brinkman: There are positions that have a value and those positions would be liquidated. Also, there are margins to cover that $53,000,000. We reestablish that $53,000,000 via the $53,000,000 margin call.

Terry Martell: Then we’re $53,000,000 net to collect. Let’s suppose there was a default in that case.

Walter Brinkman: Then we have positions to make up that $53,000,000. We can liquidate those positions we made that margin call on, and hopefully can come up with $53,000,000. For instance, if someone has 10 bean contracts, they are worth something. They have a margin and they are margined.

Warren Lebeck: The margin is over and above the current market price.

Tony Vignola: Ah, I see. We have $.20 and you lose $.20. So we call you for $.20, and we get the $.20 back. If you fail to meet that $.20, we liquidate your position and thereby have our $.20.

Terry Martell: So, there are no circumstances under which the financial integrity of the clearinghouse would be questioned, because you already have the monies.

Walter Brinkman: We’re protected for at least one day on all positions. What we’re doing is making a variation margin call which reestablishes that for the next day. So we’re protected for an additional day.

Allen Paul: Haven’t there been some clearinghouses that went broke in other markets?

Walter Brinkman: I’m sure that there have been.

Allen Paul: This is the heart of the question. We’re not asking if you are weak or vulnerable. We’re asking what the machinery is.

Walter Brinkman: Our machinery is that we monitor our clearing members and their positions very carefully. We don’t do this one day a week; we do it every day and sometimes interdays. We continually monitor the positions. We know who the participants are; we know their market share of every commodity; we know the volatility; we watch the prices all the time; we monitor the computer runs all day. So we know our exposure at any one time, at any one period every day.

Allen Paul: This really is the strength of the system you have, and it’s a reason why setting up an exchange is not a thing to be taken lightly.

Walter Brinkman: That’s correct.

Anne Peck: When you have today’s monies in hand, what happens in a situation in which you have several days of lock limit markets and you can’t liquidate the positions?

Walter Brinkman: Then it becomes not only our problem but an exchange problem as well. They have to deal with it along with us, because it’s a serious situation for them as well.

Tony Vignola: Could you work out a little T-account to Terry Martell’s question.
Walter Brinkman: You have clearing member A who has positions with margin requirements at the clearinghouse of $1,000. Suppose there is a price movement and we have to call this clearing member A for another $1,000. The first $1,000 covers the price move. We are reestablishing the $1,000 margin requirement for tomorrow morning before tomorrow comes. That’s all we’re trying to do. So, if he doesn’t give the new margin requirement to us, we take the original $1,000 and give it to clearing member B, who has a credit due him. If A doesn’t pay us the new requirement, we’ll take A’s original money and give it to B. We eliminate his positions and B gets the $1,000.

Warren Lebeck: We have to start out with the fact that there is a price at which that trade is entered into, the settlement price. Then there is this much money involved.

Walter Brinkman: Let’s say that A has positions from yesterday that required a $1,000 margin and he put it up with us. Right? Today the price moves against that position and we make a call on him for $1,000, which he doesn’t give us. Since the price is moving against us, A has to come with $1,000 more because we now owe B. If A doesn’t pay us, then we have to take his original margin of $1,000, which he gave us the day before, and give it to B.

Raleigh Wilson: If you transfer the $1,000 to B, do you do it by a transaction on the board?

Walter Brinkman: No, B is the only other party in the whole thing. We have a trust or guarantee or reserve fund of $12 million. We take the $1,000 out of that $12 million and then go after A to collect it. In collecting it from A, we would liquidate his positions in the market and get our $1,000 back.

Raleigh Wilson: This does not add or liquidate any contracts on the board or with the clearinghouse?

Walter Brinkman: Not at that point.

Warren Lebeck: Why don’t you start off with both A and B having $1,000. Maybe that will help clarify, B also has $1,000 on his trade.

Walter Brinkman: Yes, he would have $1,000 also to margin his positions.

Terry Martell: Is that $1,000 an initial margin?

Walter Brinkman: That’s a clearinghouse margin. Suppose he had one contract of T-bonds which has $1,000 margin. So A has $1,000 up and B has $1,000 up. One’s long and one’s short.

Terry Martell: Suppose A is one client of a clearing member and B is another client of the same clearing member. The clearing member then has a net margin with you of zero.

Walter Brinkman: That’s correct. He’s got an internal debit and credit, which wouldn’t even go through us. If you, as a clearing member, have customers with positions that offset in the clearinghouse or if you have no open positions in the clearinghouse but do have open positions on your books, you’ve got internal bookkeeping problems. You have to put your debits and credits together internally. That money never flows through the clearinghouse. It flows only through your house.

Allen Paul: I thought that the primary defense of either the clearinghouse dealing with the clearing members or the broker dealing with customers was not the margin (that was a secondary defense) but the legal right to sell out the contract at any time that the margin call is not met. The initial margins were kept at a level that was presumed to be more than needed by any movement in the market on the next day. As a result, any margin call is simply to bring the cushion back up to the assets. Now if there are misjudgments by the committee which sets the margins, there are other defenses which the clearinghouse has in order to save it. If you look at the history of some other exchanges, you’ll see that they had to resort to some of them. This kind of clearing mechanism appears in various places. Baer and Saxon have a fairly good description in their textbook, and I think the Clearing Corporation here has put out various materials.

To shift the ground a little bit, do the rules of the Board of Trade Clearing Corporation require the same amount of initial margin on a net
position in a contract as it does on a spread between two contract markets?

Walter Brinkman: That's right. We do not distinguish. We have no way of knowing if a position is an arbitrage position or a hedged position or a speculative position.

Allen Paul: Was the clearinghouse of the Chicago Board of Trade the first of its kind to guarantee or be legal party to all trades? I was under the impression that system was installed earlier in the Minneapolis Mercantile Exchange.

Walter Brinkman: They didn't guarantee the contracts. No clearinghouse prior to our modern-day clearinghouse in 1925 performed this function.

Allen Paul: The London Metals Exchange requires no margin, as I understand it. How do they manage with none, while you require it and an up-to-date monitoring system?

Walter Brinkman: I don't know that much about the London Metals Exchange, but there are not that many members—25 or so—and they look at each other as their banks. However, the people who trade on those exchanges are required to put up margins. The brokerage houses call them for margins and hold the margins.

Terry Martell: A concern I have is the relationship between what you said and the idea of a limit move that precludes the ability to sell a position out. What would happen, for example, in a situation in which we had several days of limit moves? Is there a potential problem there and, if so, to what degree would you see it as such?

Walter Brinkman: Back in 1973, we had 13 consecutive limit moves in soybeans. The market survived, the clearinghouse survived, and all its members were financially able to meet all their obligations.

Raleigh Wilson: You might want to explain super margins which you alluded to in your talk. In certain instances, a super margin is put on a clearing member which protects the trade and the Clearing Corporation.

Walter Brinkman: I can cite a number of cases which produced many anxious hours. Mr. Bidgood, Warren Lebeck, and we were all involved in some.

Warren Lebeck: The one I like best is the man who called me a couple of years ago and complained about having super margins on his positions. I told him that within my memory not only did governors of the Clearing Corporation have super margins put on, but at one time the chairman of the Board of Governors had super margins put on him. So there was no discrimination whatsoever. It's a matter of absolute market judgment.

Walter Brinkman: In the case of one grain company, we had it put up $90 million over and above its normal margin at the Clearing Corporation. We were concerned about that grain company because it was having financial difficulties. We were three months ahead of the bankers who didn't believe that the company was in trouble. We told the company's officers that for us to continue clearing and guaranteeing their contracts, we wanted to make sure that they had the money available to meet their obligations on a day-to-day basis. In the recent silver situation, we just called across the board on people who had silver contracts, whether they were long or short. We were equally concerned with both sides of the market. We sometimes had in excess of $200 million over and above our normal clearinghouse margins to continue guaranteeing those types of contracts. So we do exercise care. We do not hesitate to call, and we don't discriminate against people when we do call. We call across the board.

Robert McGuckin: You suggested that your margins were set for a limit move and provided you a day's cushion. My first question is, who sets the price limits. Is that the exchange?

Walter Brinkman: The exchange sets the limits independently of us.

Robert McGuckin: Well, if the exchange spreads them out, do you increase the margin?
Walter Brinkman: Not necessarily.

Robert McGuckin: Other things equal?

Walter Brinkman: Other things being equal, we are normally at the maintenance level of the Board of Trade. If the maintenance level of the Board of Trade customer margins are $.20, we’ll probably be at $.20.

Robert McGuckin: I’m not sure I understand that.

Walter Brinkman: The Board of Trade establishes initial and maintenance margins on every one of their contracts. We usually have our clearinghouse margins at the maintenance level. So if the original is $.30 and the maintenance is $.20, we are probably at $.20.

Robert McGuckin: Irrespective of what a limit move is that day?

Walter Brinkman: Usually, the maintenance level is for the limit move.

Todd Petzel: What is the function of the exchange margin?

Walter Brinkman: It establishes the minimum margins that brokers must call from their customers.

Todd Petzel: Then the commissions can be higher than that?

Walter Brinkman: The commission firm can call over and above that. They can’t call below that.

Reynold Dahl: Could you indicate the economic rational for making the Clearing Corporation a separate legal entity and not simply a part of the exchange since, if the Clearing Corporation has financial difficulty, as you indicated, it is ultimately responsible?

Walter Brinkman: We can do things much faster and more efficiently by not having to go through the committee system. I’m not demeaning the Board of Trade because they have to go through certain procedures. They are directly controlled by the United States government through the CFTC.

Warren Lebeck: In the early days, Reese, it was felt there was a Chinese wall between the Clearing Corporation and the Board of Trade. However, attorneys have told us that veil could be easily pierced now. So I think the only legitimate reason you have is just what Walter explained to you. You have two separate governments looking at two different sets of situations, although I presume you still sit in on the meetings of the Board of Trade margin committee.

Walter Brinkman: We still do.

Dustin Mirick: You talked about a limit move using up the margin and possibly having a problem with a particular clearing member. In Minneapolis where the clearing organization is part of the exchange, we have in addition to the margins required on every contract a security deposit that is required from every clearing member. Correct me if I’m wrong, but I think Chicago would have a salable piece of stock in the clearing organization. The proceeds can be used to assist in meeting a three-day or four-day limit move. Also, in Minneapolis the clearinghouse becomes the buyer to all sellers and the seller to all buyers. Your internal changes in who gains and who loses are merely bookkeeping functions on the part of the clearing organization.

Walter Brinkman: But those bookkeeping operations amount to about $100 million a day. We have to collect $100 million a day to pay $100 million a day. That’s a round turn of $200 million.

Dustin Mirick: My intention was to simplify the clearing member A/clearing member B situation.

Steve Storch: It has been asserted that the substantial increase of your margins—both the brokerage house margins as well as the Clearing Corporation’s margins—exacerbated the silver situation and ultimately forced the default on March 27. Do you have any views on that?

Walter Brinkman: In that situation, we wanted to be assured that both the long and short participants in the market could come up with the money. So we called them for over and above
the requirements of the clearinghouse. As I said, we call those super margins. I don’t think we hindered that situation. If anything, I think the Board of Trade acted very responsibly in that whole situation and performed the duty required of it.

Steve Storch: Were there timely meetings of all those margin committees of the Clearing Corporation?

Walter Brinkman: Indeed there were.

Paul Farris: What fraction of your margin calls would have to be met by liquidating positions?

Walter Brinkman: In the 12 years I’ve been at the clearinghouse, we’ve never had to liquidate a position to meet a margin call. It happened in the early 1930’s one time. I don’t think it happened in the oil scandal in 1963. I don’t think there were any positions liquidated to meet margin calls.

Terry Martell: What can be delivered to satisfy variation margin calls?

Walter Brinkman: Just cash.

Terry Martell: Presumably that cash is deposited and presumably earns interest. Who gets the interest on that money?

Walter Brinkman: No, that’s wrong. As we’re calling firm A, firm B is calling us. We allow firm B to call us for his gain in that market that day. Today we had a variation call out on the street of $188 million. We had $186 million called against us. So to answer your question about who makes the interest, it is firm B who had the favorable market.

Terry Martell: So it’s strictly safe to say that they settled.

Walter Brinkman: And they settled with same-day funds, too.

Tony Vignola: Can we get back to the same question he asked before? Suppose A didn’t come up with your $188 million today?

Walter Brinkman: Well, these were all clearing members—144 of them. This was not one clearing member that we called on for the $188 million. This was the whole street.

Tony Vignola: Hypothetically, we could isolate the example so that only one firm is involved.

Walter Brinkman: Hypothetically, then, we would have $188 million in margins from that person because of the positions he had. We would have that money starting at 8 o’clock on any given day of his position. Every day we have enough margin money to cover all open positions, and we have all cash settlements in. We’ve collected from everybody and everybody has paid.

Tony Vignola: But there’s a liability to B.

Walter Brinkman: No, there’s no liability to anybody; everybody is even. They all collected the money due them, and they all put up margins on their positions. So we start off even. Now, today if we had one market participant with $188 million market loss, we would have had, this morning, $188 million in margin money from that person.

Robert McGuckin: What happens if the person doesn’t come up with the margin? Presumably the next morning, when the market opens, you are going to liquidate his positions. But if the move is five limits away, and you can’t liquidate, what do you do then?

Walter Brinkman: I think that situation becomes an exchange problem, if not an industry-wide problem.

Robert McGuckin: Presumably there is some price at which you can liquidate.

Walter Brinkman: The Board of Trade has things that trigger all these things. I think it’s now three consecutive days. I think they are trying to change it to one consecutive day in the financials.

Robert McGuckin: Apparently in London they drop it, and then open it up and let it fly. I guess that’s the heart of the question.
Walter Brinkman: They won’t let the market lock the limit in London.

Terry Martell: There is one day’s interest someplace in the clearing operation?

Walter Brinkman: The margin money is put up in cash, but the brokerage firm that puts up the cash gets the credit for the cash. They don’t give us the cash. We get a certificate of evidence that there’s a cash deposit. That’s all we get. So the brokerage firm invests that money that’s in segregation and earns interest on it.

Jeffrey Williams: You proudly state that there has never been a need to sell out for many years, but in some sense that indicates that the margins are set too high. Occasionally you would want to use your second line of defense, otherwise, your first line is too large. Since you started by saying that you set the margins only to insure the financial integrity, maybe this indicates that it’s a little too big.

Walter Brinkman: We’ve had studies performed on this by Dr. Breeden from Stanford. He has reassured us that our margins protect the volatile movement in all the markets. They’re not high and they’re not low. They’re just adequate.

Allen Paul: Is the clearing fee the only source of income to the Clearing Corporation to pay the salaries, etc. it has? You don’t have a source of income other than that?

Walter Brinkman: That’s right. The only source of income we have is the clearing fee we charge, which is $.05 per contract. That’s the only source of revenue we have. We don’t make a cent on margin money.
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