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OFFICE OF THE SECRETARIAT

December 7, 2001

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549

### COMMENT

Ms. Jean Webb  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581

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Re: File No. S7-16-01; Customer Margin for Security Futures

Dear Mr. Katz and Ms. Webb:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to submit comments on proposed rules issued jointly by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") that would establish customer margin requirements for security futures. See 66 FR 50720 (October 4, 2001) (the "Joint Release"). CBOE joins in and fully supports the separate comment letter that is being submitted by The Options Clearing Corporation and all five U.S. options exchanges covering those issues where a common position among the organizations was agreed. CBOE is submitting these separate comments on the issue of who should qualify as a "market maker" and therefore be exempt from the customer margin requirements.

CBOE has a strong interest in this subject from two perspectives. First, CBOE is a participant in OneChicago, LLC, the joint venture among Chicago's three derivatives exchanges that is establishing a market for trading security futures. Accordingly, CBOE believes that the margin rules should not discourage individuals and firms from acting as market makers in security futures and thus providing the liquidity needed so that trading in this product can grow and develop. At the same time, CBOE is the largest options exchange in the world and the Commodity Futures Modernization Act of 2000 ("CFMA") requires consistent margin treatment between security futures and security options.

Under Section 7(c)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), the financing of the market-making activities of a member of a national securities exchange or a registered broker-dealer is exempted from federal margin regulation (the "Market Maker Exemption"). Section 3(a)(38) of the Exchange Act defines a market maker as any dealer who holds himself out (by entering quotations in an interdealer quotation system or otherwise) as being willing to buy or sell such security for his own account on a regular or continuous basis. On a floor-based exchange operating via open outcry, it is fairly easy to denominate market makers as the persons who trade for their own account on a regular basis and fulfill other affirmative market-making criteria imposed by the exchange. Although each market maker may not quote continuously, his physical presence on the floor and his willingness to respond to orders presented to the trading crowd can be construed as "holding himself out" as willing to buy or sell securities. The options exchanges also impose certain affirmative obligations (e.g., zone requirements, in-person requirements, the obligation to verbalize a quote in response to a customer order, etc.) to ensure that the market maker provides liquidity in a core group of securities.<sup>1</sup>

For purposes of this proposed rulemaking, the critical questions concern how the Market Maker Exemption should apply (1) to floor traders at open-outcry futures exchanges<sup>2</sup> and (2) to persons who trade on screen-based trading systems.

### **Futures Exchange Floor Traders**

Floor traders at futures exchanges, unlike specialists and market makers at securities exchanges, do not have affirmative market-making obligations. As noted in the Joint Release, the Federal Reserve Board has taken the position that futures exchange floor traders act as market makers and thus qualify for the Market Maker Exemption when trading in the current open-outcry environment.<sup>3</sup> While not subject to affirmative obligations, floor traders on open outcry futures exchanges provide liquidity by buying and selling for their own account on a regular or continuous basis. So that futures floor traders are not penalized by the different regulatory construct under which they operate, the Federal Reserve Board concluded that they should be eligible for the Market Maker Exemption. CBOE agrees with that position for a product such as security futures, which entails both securities and futures rules, but believes that further analysis is needed to define the scope of the applicable exemption.

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<sup>1</sup> See e.g., CBOE Rule 8.7.

<sup>2</sup> For purposes of this comment letter, the term "futures exchange" refers to designated contract markets and derivative transaction execution facilities.

<sup>3</sup> Letter dated March 6, 2001, from Jennifer Johnson, Secretary of the Federal Reserve Board, to Acting Chairman James E. Newsome, CFTC, and Acting Chairman Laura S. Unger, SEC.

CBOE believes that when a member of a futures exchange, acting as a floor trader, trades security futures products that are traded on such futures exchange by open outcry, the member should qualify for the Market Maker Exemption. Given the need to forgo reliance solely on affirmative obligations in the security futures context, the grant of market maker status for margin purposes to all floor traders on an open outcry security futures exchange is reasonable. Due to the physical space constraints of a trading floor, the number of persons who can qualify for market maker treatment is limited. Moreover, the physical presence on the trading floor connotes a full-time devotion to trading and to bidding or offering in response to orders brought to the floor. However, it does not follow that every floor trader at every futures exchange should qualify for the exemption. For example, a floor trader in crude oil futures at the New York Mercantile Exchange is not acting as a market maker when he places an order to buy or sell a security futures product that is traded at another exchange if the New York Mercantile Exchange does not trade security futures. In other words, a futures exchange floor trader should qualify for the Market Maker Exemption only if his exchange trades security futures (and the floor trader meet certain capital requirements, described below).

The treatment of this issue in the Joint Release is confusing. Immediately following the sentence noting the Federal Reserve Board's position that futures exchange floor traders qualify for the Market Maker Exemption when trading by open outcry, the Joint Release makes the following statement: "For clarity, the Commissions are proposing to specify under Proposed CFTC Rule 41.43(b)(3)(iv)(B) and Proposed SEC Rule 400(b)(3)(iv)(B) that credit extended by a broker, dealer or member of a national securities exchange that is exempt under Section 7(c)(3) of the Exchange Act would also be excluded from the proposed rules."<sup>4</sup> Yet the rules referred to in that sentence simply provide that anyone who qualifies for the statutory exemption is not subject to the proposed margin rules; they say nothing about floor traders, open outcry or any other factors that would provide guidance in determining whether someone qualifies for the exemption. When adopting final margin rules for security futures, the Commissions should make clear under what circumstances floor traders on an open outcry exchange will be eligible for the Market Maker Exemption.

### **Screen-Based Trading Systems**

The Commissions noted in the Joint Release that certain exchanges intend to list security futures products that will be traded on a screen-based trading system. Accordingly, the Commissions propose to exclude from the scope of their margin rules certain exchange members who have market maker obligations. In CBOE's view, there is no need to have one set of rules to determine who qualifies for the Market Maker Exemption in open outcry trading, and another set of rules to make that determination under screen-based trading. We believe that a uniform set of standards should be adopted that would encompass all forms of trading systems, although we recognize that how those standards would be satisfied could differ depending on the trading method used.

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<sup>4</sup> Joint Release at 50725.

It is more difficult to determine who qualifies as a market maker in security futures on a screen-based trading system than on an open outcry market for two reasons. First, given the lack of physical constraints normally accorded by a trading floor, an electronic exchange can have an unlimited number of members it authorizes as market makers. If it offers a cheap enough membership, such an exchange could allow any person who trades for his or her own account to qualify as a market maker. Second, on the other hand, an unduly restrictive standard for being a market maker on an electronic system (for example, by requiring continuous quotes) could unnecessarily prevent active liquidity suppliers from receiving market maker treatment. Active professionals in financial derivative products can provide liquidity on an electronic system that is equivalent to futures exchange floor traders on an open outcry exchange without necessarily providing continuous quotes. Consequently, CBOE believes it is appropriate to consider one of two alternatives to determine whether the trader is a liquidity provider in security futures products: (1) is the trader a full-time registered securities or futures professional as evidenced by registration with the SEC or CFTC and membership on a security futures exchange; or (2) lacking registration with the SEC or CFTC, does the trader evidence professional liquidity provider status by his business activity. We discuss these alternatives in detail below. Although these alternatives are broader than traditional indicia of market makers in the securities markets context, they make eminent sense given the Federal Reserve Board's position that providing liquidity on a regular basis on an open outcry exchange, without an affirmative obligation to do so, is an acceptable criterion for a security futures market maker.

Proposed CFTC Rule 41.43(b)(3)(iv)(C) and SEC Rule 400(b)(3)(iv)(C) would establish criteria for determining when a member of a national securities exchange or a national securities association would be eligible for the Market Maker Exemption. The member must not accept or solicit orders from any customer or provide advice to any customer in connection with the trading of security futures. The member must also be registered with such exchange or association as a "security futures dealer" pursuant to rules that require such member:

- (1) to be registered as a floor trader or floor broker with the CFTC, or as a dealer with the SEC;
- (2) to comply with applicable SEC or CFTC net capital requirements;
- (3) to maintain records sufficient to prove compliance with these requirements; and
- (4) to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis.

In addition, the rules of the exchange or association must provide for disciplinary action against a member for its failure to comply with applicable rules.

CBOE generally supports most of the criteria in the proposed rules for determining when someone is eligible for the Market Maker Exemption. However, as discussed below, we believe

that certain of the criteria should be modified given that the Federal Reserve Board does not require affirmative obligations for a securities futures dealer.

### **Suggested Eligibility Standards**

In CBOE's view, the eligibility standards for determining who qualifies for the Market Maker Exemption, whether on an open outcry exchange or an electronic exchange, should include a combination of criteria designed to establish the professional, liquidity-provider role of the market participant. We provide below two suggested alternatives for eligibility. A person who satisfies either of the two alternatives would be deemed a market maker for security futures purposes.

#### **Alternative A**

Under our Alternative A, a person or entity must satisfy **all three** of the **regulatory criteria** described below in order to qualify for the exemption.

1. **Exchange Member.** The person or entity must be a member of a national securities exchange or national securities association that lists security futures for trading, must have trading privileges in security futures as a member, and must be subject to the rules of the exchange or association. This criterion is consistent with Proposed CFTC Rule 41.43(b)(3)(iv)(C) and Proposed SEC Rule 400(b)(3)(iv)(C). Under this criterion, non-members, even those with direct electronic access to a market trading security futures, would not be eligible for the Market Maker Exemption.

2. **Registration Status.** The person or entity must be registered as a broker-dealer under the Exchange Act or as a floor broker or floor trader under the Commodity Exchange Act. Registration is one way to distinguish market professionals from casual traders. This criterion is consistent with Proposed CFTC Rule 41.43(b)(3)(iv)(C)(2)(i) and Proposed SEC Rule 400(b)(3)(iv)(C)(2)(i).

3. **Subject to Appropriate Net Capital Requirement.** In order to qualify for the Market Maker Exemption, the person or entity must be subject to an appropriate net capital requirement applicable to such person or entity or to the clearing member firm that clears the trades of such person or entity. Thus, our proposed rules would require members to comply with applicable SEC or CFTC net capital requirements. CBOE believes that the net capital requirements for persons acting as market makers in security futures should be uniform, regardless of whether such persons are subject to the SEC or the CFTC net capital rule. Under the SEC net capital rule, a securities options market maker is exempted from the rule, provided that his clearing firm takes an immediate capital haircut for the positions held in the market maker's account.<sup>5</sup> In contrast, under the CFTC net capital rule, a futures commission merchant

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<sup>5</sup> Exchange Act Rule 15c3-1(c)(2)(x).

("FCM") is not required to take a capital deduction for an undermargined floor trader's account until a margin call has been outstanding and unsatisfied for three business days.<sup>6</sup> The CFMA clearly prohibits inconsistent regulatory treatment between security futures and security options in margin regulation, of which market maker financing is one aspect. Thus, CBOE believes that all persons who are treated as market makers in security futures must have an equivalent capital requirement in order to prevent security futures market makers regulated by the CFTC from obtaining an unfair competitive edge over security futures or security options market makers regulated by the SEC.

### **Alternative B**

Under the CFTC's rules for screen-based trading systems, an exchange member may not be required to register with the CFTC.<sup>7</sup> For persons who do not register with the CFTC or SEC, as long as they satisfy the first and third regulatory criteria under Alternative A, we would recommend granting them market maker margin status under Alternative B if they also satisfy one of the two alternative market participation tests set forth below. Like SEC/CFTC registration, the market participation tests distinguish market professionals from casual traders.

1. **Affirmative Obligations.** For those exchanges that impose an affirmative obligation on market makers to quote on a regular or continuous basis in security futures,<sup>8</sup> any member who meets that requirement would qualify for the Market Maker Exemption.

**Or, in the alternative,**

2. **Principal Business Activity.** Under this test, a member could demonstrate that he is a regular participant in the security futures market such that trading in security futures is a part of his principal business of providing liquidity in listed financial-based derivatives on a regular or continuous basis. To satisfy this test, a large majority (*e.g.*, 75%) of the member's revenue from business activities or occupations would have to be derived from trading listed financial-based derivatives (*i.e.*, security futures, stock index futures, stock and index options, foreign currency futures and options, and interest rate futures and options) on any exchange in the capacity of a member. We would not limit the revenue test to trading security futures only

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<sup>6</sup> CFTC Rule 1.17(c)(5)(viii).

<sup>7</sup> The CFTC has delegated its registration authority to the National Futures Association, but for the purposes of this comment letter, CBOE will refer to registration with the CFTC.

<sup>8</sup> On an electronic exchange, this could be evidenced by posting two-sided quotes, responding to a percentage of requests for quotes, or other reasonable criteria.

because we believe that a member who adds liquidity to the security futures market is likely to trade in related financial derivatives markets for hedging and arbitrage, and vice versa.<sup>9</sup>

Under the Principal Business Activity test, the member should also satisfy other criteria designed to demonstrate that he acts as a liquidity provider on the exchange or exchanges of which he is a member, and does not conduct most of his activity on exchanges of which he is not a member. Hence, the member should have to trade for his own account on any exchange in the capacity of a member on at least 75% of the trading days in the calendar quarter. In addition, 50% of the member's total trading activity must be conducted in listed financial-based derivative products on the exchange or exchanges where he is a member. Finally, the member should be assigned as a liquidity provider in a specific number of security futures contracts and conduct a majority of his security futures trading in those contracts. These criteria are designed to prevent an electronic exchange from granting inexpensive memberships to persons who then conduct most of their trading on other exchanges. If, taking into consideration all financial-based derivatives activities effected for his own account on the exchanges of which he is a member, the person satisfied these standards, he could qualify for market maker treatment for all security futures contracts.

### **Conclusion**

CBOE believes that using a combination of regulatory and market participation criteria, as described above, is consistent with both the statutory language of the Commodity Futures Modernization Act and the intent of the statute. From an administrative standpoint, these criteria draw a clear line that distinguishes between professional liquidity providers with an established regulatory status from persons trading security futures on a casual or non-professional basis. It will be obvious to the participant and the exchange in almost every instance whether or not the trader satisfies the criteria described above to deserve market maker margin treatment for security futures contracts.

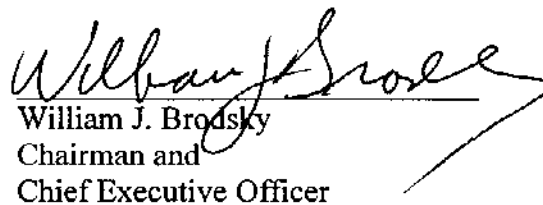
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<sup>9</sup> Operationally, either test would be evaluated on a quarterly basis so that if a member failed to meet the criteria in a quarter, the exchange could take action to strip the member of the market maker designation or put the designation on probation for the next quarter.

Mr. Jonathan G. Katz  
Ms. Jean Webb  
December 7, 2001  
Page 8

We appreciate the opportunity to submit comments on a subject that is of great importance to our market. If you have any questions, please call Joanne Moffic-Silver or Mary Bender at the Exchange.

Sincerely,

  
William J. Brodsky  
Chairman and  
Chief Executive Officer

cc: Chairman Harvey Pitt, SEC  
Annette Nazareth, SEC  
Elizabeth King, SEC

Chairman James Newsome, CFTC  
Elizabeth Fox, CFTC