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The American Stock Exchange
Chicago Board Options Exchange
International Securities Exchange
The Options Clearing Corporation
Pacific Exchange
Philadelphia Stock Exchange

December 5, 2001

COMMENT

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RECORDS SECTION

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Ms. Jean Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: S7-16-01, Customer Margin Rules Related to Security Futures

Dear Mr. Katz and Ms. Webb:

The American Stock Exchange ("AMEX"), the Chicago Board Options Exchange ("CBOE"), The Options Clearing Corporation ("OCC"), the International Securities Exchange ("ISE"), the Pacific Exchange ("Pacific"), and the Philadelphia Stock Exchange ("Phlx") are pleased to comment on File No. S7-16-01, "Customer Margin Related to Security Futures."[1] In this release, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") proposed rules to establish customer margin requirements for security futures. The proposed rules are intended to preserve the financial integrity of markets trading security futures, prevent systemic risk, and require that margin requirements for security futures be consistent with the margin requirements for comparable exchange traded option contracts. Our comments do not address the exclusion from the proposed rules of market makers on screen-based exchanges. In light of differing views among the above-named exchanges on the proper criteria for determining who is a market maker on a screen-based exchange, some or all of those exchanges may determine to submit separate comment letters on this

[1] Securities Exchange Act, Release No. 44853 (September 28, 2001), 66 FR 193 (October 4, 2001).

issue. In addition, OCC plans to submit a comment letter on the appropriate attributes or considerations for a portfolio based margining system at the customer level.

We were active participants in the legislative process that led to the passage of the Commodity Futures Modernization Act of 2000 ("CFMA"). The main focus of our efforts was to insure that the legislation created regulatory parity between long-established exchange traded options and the newly created security futures product. Margin was an issue of particular concern. We stressed that, unless security futures margin were equivalent to exchange traded options margin, substantial competitive disparities would result as well as the potential for security futures to destabilize the equity markets.[2] These concerns were addressed in the final version of CFMA. The CFMA attempts to provide virtually identical regulatory treatment of exchange traded options and security futures in core regulatory areas in order to eliminate regulatory disparities that would create artificial competitive inequities between these products.[3] Margin is perhaps the most important area in which the CFMA mandates regulatory consistency between exchange traded options and security futures. As discussed below, the CFMA explicitly requires equivalent regulatory margin standards between the two products. It is critical that the rules adopted by the SEC and CFTC stay true to the language and purpose of the CFMA provisions relating to security futures margin. As discussed below, we believe that the proposed rules fulfill this goal.

The CFMA requires that customer margin rules must be "consistent with the margin requirements for comparable option contracts traded on any [security options] exchange."[4] Under the CFMA, initial and maintenance margin levels for security futures shall not be "lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any [security options] exchange."[5] Finally, the

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[2] All of the undersigned exchanges are members of the U.S. Securities Markets Coalition. The Coalition also includes the Boston Stock Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, and NASDAQ, who are not participants in this letter. During consideration of the CFMA, Chicago Board Options Exchange Chairman Bill Brodsky testifying on behalf of the U.S. Securities Markets Coalition noted that futures exchanges had suggested that they might agree to margin requirements for security futures that were "similar" to those that apply to exchange-traded security options as opposed to equivalent. He asked rhetorically, "Would the futures exchanges agree to a 20 percent margin level for single stock futures with any changes approved by the SEC, as is the case for stock options? Anything less than this is a hollow offer." H. Rep. 106-43, 106th Cong., 2nd Sess. 170 (2000).

[3] The House Commerce Committee Report on the CFMA states:

> For security futures, margin requirements, suitability, sales practice rules, and transaction fees are harmonized between options and futures markets to minimize competitive disparities between the markets H.R. Rep. 106-711, Part 3, 106th Cong., 2d Sess. 48 (2000).

[4] 15 U.S.C. 78f(a).

[5] 15 U.S.C. 78(c)(2)(B)(iii).

rules must ensure that "margin requirements (other than levels of margin), including the type, form and use of collateral" for security futures "are and remain consistent" with those applicable to securities.[6] The approach of the proposed rules adheres faithfully to the statutory requirements for customer margin for security futures. We commend the SEC and CFTC for proposing rules that fulfill the statutory requirements and maintain regulatory parity between exchange traded options and security futures. For this reason, with the exception noted above regarding the definition of market maker, we strongly support the proposed rules and urge the agencies to adopt final rules in substantially the same form as the proposed rules.

The proposed rules provide that the requirements of Regulation T, other than margin levels, apply to financial relations between a creditor, as that term is used in Regulation T, and a customer with respect to security futures. The SEC and CFTC state that a second approach would be to issue comprehensive stand-alone margin rules that would parallel Regulation T requirements for securities to the extent that such requirements are relevant to security futures. We support the proposal to apply Regulation T, other than margin levels, to security futures. The alternative approach of stand-alone rules would not meet the statutory requirement that "margin requirements (other than levels of margin), including the type, form and use of collateral" for security futures "are and remain consistent" with those on securities.[7] In the context of the statute, we understand the term "consistent" to mean that there can be no appreciable difference between the rules applicable to exchange traded options and those applicable to security futures. The only way to ensure that there is no appreciable difference is to apply the same regulations and interpretations to both products. Over time, there is a great risk that a stand-alone rule will vary materially from Regulation T, as applied, because of the difficulty of promptly incorporating the Federal Reserve Board's future interpretations of Regulation T into stand-alone rules. Stand-alone rules would require joint rulemaking or interpretive releases by the SEC and CFTC every time the Federal Reserve Board modified Regulation T or interpreted those provisions. It is possible, if not likely, that in the future the necessary joint agency action would lag Federal Reserve Board action or fail to follow precisely the Federal Reserve Board interpretation. These variations could result in inconsistent margin treatment between security futures and exchange traded stock options.

We recognize that futures commission merchants ("FCMs") are not used to complying with Regulation T and thus may have to make some initial operational adjustments to accommodate Regulation T. This accommodation is a necessary byproduct of enabling a securities product to be traded by FCMs. There are many aspects of the securities laws that will be applied to security futures and which do not apply to futures that are not regulated as securities. For example, security futures will be subject to options-like

[6] 15 U.S.C. 78(c)(2)(B)(iv).

[7] 15 U.S.C. 78(c)(2)(B)(iv).

suitability rules, insider trading prohibitions, best execution standards, and physical delivery of equity securities. FCMs will have to revise account opening, compliance and operational procedures to ensure compliance with these securities law provisions. There is no compelling reason to single out margin procedures for stand-alone rules for FCMs, especially given the potential for stand-alone rules to result in regulatory divergence.

The proposed rules would exempt from security futures margin levels any portfolio margining system approved by the two agencies. The exemption from margin rules for any portfolio margining system for securities approved by the SEC is already embodied in Regulation T. The proposed rules reflect the recommendation of the Federal Reserve Board in its delegation of margin authority to the SEC and CFTC encouraging portfolio margining for security futures.[8] We agree that security futures products should be part of any portfolio margining system involving individual stocks and stock options. Moreover, we are very pleased that the SEC and CFTC are strongly encouraging the efforts of market participants to develop a portfolio margining system. The undersigned exchanges and OCC have long sought approval of portfolio margining at the customer level for options. Portfolio margin requirements would help attune margin requirements to the actual risk of a customer's portfolio. Nevertheless, it is critical that any portfolio margining system applicable to security futures apply to all related products, including listed stock options and the underlying stocks. Portfolio margining should not be approved for security futures before it is approved for exchange traded options. Any result to the contrary is inconsistent with the CFMA and the very nature of portfolio margining.

We understand that some market participants might recommend that a portfolio margin approach be applied to security futures at, or close to, the outset of trading in these products. A sound and practical approach to portfolio margining for broad-based index equity products has already been proposed for implementation on a pilot basis. This pilot program, developed by the CBOE, working in cooperation with OCC, the New York Stock Exchange, AMEX, the Chicago Board of Trade and the Chicago Mercantile Exchange, would permit portfolio margining for certain customers in broad-based stock index options and futures positions.[9] As this portfolio approach is derived from OCC's Theoretical Intermarket Margin System ("TIMS"), a methodology currently used by the OCC to margin clearing member options, futures and underlying positions, it is expandable to accommodate the portfolio margining of any equity products for customer

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[8] See Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC, March 6, 2001.

[9] The pilot program would be available for (1) any registered broker or dealer registered with the SEC pursuant to Section 15(b)(1) of the Exchange Act; (2) any affiliate of a self-clearing Exchange Act Section 15(b)(1) registered broker-dealer; (3) any registered futures floor trader to the extent that listed index options positions hedge the trader's index futures and options positions; and (4) any person or entity that has or, establishes and maintains equity of at least five million dollars across all securities and futures accounts under his/her/its common ownership.

accounts.[10] However, there are attributes native to the risk of individual equity products that are not as pronounced for broad-based stock index options and futures products, namely volatility and correlation, which require additional consideration prior to incorporation as inputs into a risk-based methodology. Once the markets, firms, and regulators have gained experience with the pilot for broad-based index options and futures products, we enthusiastically support the expansion of the pilot program to include security futures, stock options and the underlying stocks (as long as all equity products are included). The first step is for the SEC and CFTC to approve the broad-based index pilot as soon as possible.

The proposed rules would establish initial and maintenance margin levels for customers carrying a long or short security futures position at 20 percent of the position's "current market value," as defined in the proposed rules.[11] We strongly support at least a 20 percent initial and maintenance margin level for security futures as the amount necessary currently to comply with the CFMA mandate that security futures margin levels be no lower than the level for comparable security options, exclusive of the premium.[12] Currently, long security options positions must be fully paid for in most circumstances while short options positions require a margin of the premium received plus 20 percent of the value of the underlying instrument. During consideration of the CFMA, we consistently stressed that security futures margin needed to be at least 20 percent to be equivalent to security options margin. This is because the risk posed by a short options position is analogous to that of a security futures position and thus provides a reasonable criterion for determining the appropriate margin level. Moreover, even if one uses a synthetic futures position comprised of options as the appropriate proxy for determining the margin level, the regulations still would require, at a minimum, 20 percent at this time.[13] The participants in the legislative process clearly acknowledged that the 20 percent level was the minimum amount necessary to satisfy the CFMA provisions given the existing margin levels applicable to exchange traded options. Any result less than a 20 percent initial and maintenance margin level for security futures would contradict the clear provisions of the CFMA and would result in the regulatory disparity that the statute was intended to prevent. Although 20 percent represents the level needed for equivalency with options currently, should options margin be increased beyond 20%, securities futures margin would have to be increased accordingly. Thus, the rules should provide some mechanism for increasing security futures margin automatically should stock options margin be raised.

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[10] A separate comment letter by OCC discusses, in greater detail, the appropriate attributes or considerations for the development of a portfolio based margining system at the customer level.

[11] Proposed CFTC Rule 41.44(a)(2); SEC Proposed Rule 242.401(a)(2).

[12] This margin level should be reviewed upon implementation of a portfolio margining system for individual equity products.

[13] A synthetic short future would be replicated by a long put and a short call on the same stock while a synthetic long future would be replicated by a long call and short put on the same stock.

While we are cognizant of the fact that FCMs are not accustomed to computing margin as a straight percentage, we do not believe that compliance with the proposed margin requirement poses an overly burdensome operational adjustment. We believe that a futures margining system could be coded to compute a 20% margin on security futures, and that FCMs could, therefore, fit security futures into their current structure. There should be no obstacle to the use of a futures margining system by FCMs, provided the system programming is configured to render a margin requirement which is not less than the level proposed by the SEC and CFTC.

The proposed rules also permit exchange rules to provide that customers with strategy-based offset positions involving security futures and one or more related securities or futures have minimum initial and maintenance margin levels lower than the aggregate margins for the components of an offset position, provided that such minimum levels of margin are consistent with the margin requirements for comparable offset positions involving exchange traded option contracts. We support these provisions of the proposed rules. We support the use of permitted offsets for security futures as long as the offsets match those allowed for security options. The allowable offsets contained in the proposed rules accomplish this. Margin offsets recognize the reduction in risk from hedged positions and appropriately decrease margin to reflect the lessened risk.

With respect to an offset on initial margin for hedged security futures positions, we would support a reduction in margin to 10% only if the risk from the futures positions were completely offset by the options hedging the risk. Thus, a short futures position could be offset by a long call option on the same underlying stock with an expiration date at or after the futures contract (or by a long call/short put synthetic future), but not solely by a short put. Similarly, a long futures position could be offset by a long put option on the same underlying with an expiration date at or after the futures contract (or by a long put/short call synthetic future), but not solely by a short call. It is reasonable to provide offset treatment for initial margin where the risk is completely hedged, but not where the risk is covered only to the extent of the options premium received.

The proposed rules provide that cash, margin securities as defined in Regulation T, exempted securities as defined in Section 3(a)(12) of the Exchange Act,[14] or other collateral permitted under Regulation T are permitted collateral to satisfy margin requirements. Under the proposed rules, security futures are not margin securities. We support these aspects of the proposed rules because they are consistent with the rules applicable to exchange traded options contracts. The permitted collateral for security futures mirrors the permitted collateral for exchange traded options contract margin. Short options do not have loan value for margin purposes. Security futures should not

[14] 15 U.S.C. 78c(a)(12).

have loan value for margin purposes either in order to satisfy the statutory mandate of consistency.[15]

We support the SEC and CFTC rule review processes for rule changes relating to security futures margin. These rule review processes closely track the statutory requirements.[16] The statutory requirements for security futures margin changes, other than raising margin, insure that the SEC can fully review such rule changes in the context of the CFMA's mandate to maintain consistency between margin and margin requirements applicable to exchange traded options contracts and security futures. The statutory requirements provide that the CFTC, as the joint regulator of markets offering security futures, is notified of any rule changes related to security futures margin.

Thank you again for the opportunity to comment on the proposed rules. If you would like to discuss any of these issues further, please contact Michael Walinskas or Susan Milligan at The Options Clearing Corporation at (312) 322-4451 or (202) 756-7756, respectively.

Sincerely,

The American Stock Exchange
Chicago Board Options Exchange
International Securities Exchange
The Options Clearing Corporation
Pacific Exchange
Philadelphia Stock Exchange

cc: Chairman Harvey Pitt, SEC
Annette Nazareth, SEC
Elizabeth King, SEC
Chairman James Newsome, CFTC
Elizabeth Fox, CFTC

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15 15 U.S.C. 78(c)(2)(B)(iv).

16 15 U.S.C. 78s(b) and 7 U.S.C. 7a-2(c).