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COMMENT

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December 6, 2001

BY FACSIMILE AND ELECTRONIC MAIL

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Re: Customer Margin Rules Relating to Security Futures Products (SEC File No. S7-16-01)

Dear Ms. Webb and Mr. Katz:

OneChicago, LLC ("OneChicago")[1] is submitting this comment letter in response to the joint release issued by the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") (collectively, the "Commissions") proposing new Rules 400 through 404 under the Securities Exchange Act of 1934 (the "Exchange Act") and new Rules 41.43 through 41.48 under the Commodity Exchange Act (the "Proposed Rules") relating to the establishment of margin requirements for security futures products.[2]

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[1] OneChicago is a joint venture among the Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Mercantile Exchange Inc. ("CME") and the Board of Trade of the City of Chicago, Inc. ("CBOT") that was formed to provide a trading facility for security futures products. We understand that the CBOE, CBOT and CME will also be submitting comment letters.

[2] 66 Fed. Reg. 50720 (October 4, 2001), Securities Exchange Act Release No. 44853 (September 26, 2001).

I. Summary.

OneChicago commends the Commissions for working together to develop a comprehensive approach to the margin treatment of security futures. This was a formidable task, and OneChicago believes that the Commissions and their staffs deserve recognition for the tremendous effort that a rulemaking of this complexity necessarily entails. OneChicago nonetheless offers the following comments and suggestions which, it believes, will help assure that the Proposed Rules do not create undue regulatory burdens or stifle the development of the security futures markets:

- OneChicago endorses the Commissions' proposal to establish a 20 per cent initial and maintenance margin requirement.

- The Proposed Rules should be modified to make the margin account and related requirements of the Proposed Rules inapplicable to a futures commission merchant if it is carrying customer positions in security futures contracts in a segregated funds account. By contrast, a broker-dealer which elects to carry security futures in a securities account or that is registered with the CFTC pursuant to the notice provisions of the Commodity Exchange Act would remain fully subject to those requirements.

- The Commissions should work with the national securities exchanges and national securities associations (collectively, the "SROs") and the contract markets to expedite the implementation of portfolio margining at the customer level.

- The Proposed Rules should be revised or clarified as necessary to ensure the equal treatment of securities and futures market makers and of broker-dealers, futures commission merchants and floor brokers.

- The Commissions should monitor the adoption, interpretation and enforcement of margin rules by the SROs and the contract markets to ensure that they do not unreasonably inhibit the development of security futures markets.

II. The 20 Per Cent Margin Requirement Should Not Be Changed.

OneChicago strongly endorses the Commissions' proposal to set the initial and maintenance margin levels for security futures at 20 per cent. This standard is consistent with the understandings reached by the SEC and CFTC during the legislative process that led to the enactment of the Commodity Futures Modernization Act of 2000 ("CFMA") and should not be modified absent compelling evidence that such a change is required by Section 7(c)(2) of the Exchange Act.' The SEC and CFTC staffs thoroughly evaluated margin practices in the

securities and futures industries prior to the enactment of the CFMA. It was on the basis of that analysis that it was agreed that the margin level for security futures should be comparable to that of securities options, as required by what is now Section 7(c)(2) of the Exchange Act. Options generally are subject to an effective margin level of 20 per cent, and it was understood that the application of such a standard would create a "level playing field," while simultaneously helping to ensure the financial integrity of the markets and prevent systemic risk, as also required by Section 7(c)(2). Nothing that has happened in the interim should cause the Commissions to reevaluate that determination. To the extent that a broker-dealer or futures commission merchant believes that the minimum margin in particular cases is insufficient, it remains free to require a greater amount. OneChicago accordingly urges the Commissions not to alter this aspect of the Proposed Rules.

III. The Application of Regulation T to Futures Accounts Is Impractical and Unnecessary.

Section 7(c)(2)(B)(iv) of the Exchange Act provides that the margin requirements (other than levels of margin) for security futures products, including the type, form and use of collateral, must be and must remain consistent with the requirements established by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") pursuant to Regulation T. The Proposed Rules would implement this statutory mandate by requiring that the margin account provisions of Regulation T apply to the financial relations between a creditor and a customer with respect to security futures and any related offset positions.

OneChicago respectfully submits that such a result is not required. As discussed in more detail below, OneChicago believes that the requirements of the Exchange Act can be fairly addressed by permitting the margin treatment of security futures contracts to be determined, to the maximum extent possible, by whether these contracts are held in a futures account or in a securities account, subject either to 20 per cent minimum initial and maintenance margin requirements or to such lesser amount as may be required pursuant to the portfolio margining rules of an SRO.

The Commissions' proposal would appear to be based on the assumption that the margin account provisions of Regulation T must be applied to security futures if the margin requirements for these products are to remain "consistent" with the requirements established by the Federal Reserve Board. Congress authorized the Federal Reserve Board to take such steps as were necessary to develop a regulatory scheme that would preserve market integrity and prevent systemic risk in a manner that is "consistent," but not necessarily "identical" or "equivalent," to the arrangements in effect for securities options.[3] A rigid adherence to the margin account

[3] Section 7(c)(2) of the Exchange Act authorizes the Federal Reserve Board to delegate the authority conferred therein to the Commissions. Section 7(c)(2) makes clear that the same

provisions of Regulation T is not required by Section 7(c)(2) of the Exchange Act, as evidenced by the fact that Regulation T itself defers in significant respects to the rules of the registered securities exchanges or registered securities associations on which securities options are traded.[4]

The application of the substantive provisions of Regulation T would have significant adverse consequences for futures commission merchants that are registered as broker-dealers pursuant to the notice provisions of Section 15(b)(11) of the Exchange Act (hereafter, "FCMs") and their customers. The existing account structure used by FCMs involves a single account in which all customer property, including cash and other assets, is deposited. By contrast, Regulation T requires broker-dealers to record securities transactions in one or more of five different accounts.[5] Requiring FCMs to establish margin accounts for customers that trade security futures would impose substantial operational and administrative costs on those FCMs.

The bookkeeping and customer support systems that are used in the futures industry would require significant adaptation to accommodate the strictures of Regulation T because the rules governing the margin requirements for futures customers constitute an integral part of these systems.[6] The margin rules of the contract markets are not uniform, however, and an FCM may not accept as margin to secure a customer's positions on a given exchange a form of collateral that is not permitted by the rules of that exchange. As a consequence, the automated systems that are employed by FCMs must calculate each customer's margin requirements on each exchange and measure those requirements against the forms of margin deposit that are permitted by the exchange in question.

The systems employed by FCMs for this purpose are already highly complex. That complexity is ameliorated, however, by an FCM's ability to hold all of a customer's futures

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standards are to apply, regardless of whether the rules in question are adopted by the Federal Reserve Board or by the Commissions.

4 12 C.F.R. § 220.12(f).

5 *See* 12 C.F.R. §§ 220.3(a), 220.4 - 220.7 (2001).

6 In general, those systems are highly complex and integrated Web-enabled packages that capture trade data and position information; deliver that information electronically to the relevant exchanges and clearing organizations; import intraday and settlement prices to enable FCMs to monitor their compliance with net capital, segregation and customer margin requirements; generate customer confirmation, purchase-and-sale, and monthly statements for multiple markets on a consolidated, multicurrency basis (so-called "global clearing"); process delivery and option exercise and assignment notices and instructions; offer real-time analysis of customer and proprietary positions against designated risk arrays; and process required regulatory and compliance reports.

positions and related margin deposits *in a single account*. Thus, for purposes of determining whether a customer is undermargined (and, in turn, whether the firm is undersegregated or undercapitalized), an FCM can analyze the value of the positions and the collateral in a customer's account on an aggregate basis, subject only to ensuring that any such collateral is compliant with the requirements of the relevant exchange(s) on which the customer is trading. Superimposing the requirements of the Proposed Rules, including the separate cash, margin, special memorandum and good faith account requirements of Regulation T, will strain the capacity of these systems by isolating security futures from all other futures contracts (and options on futures contracts) and requiring separate and independent calculations for each set of accounts.

A further consequence of these requirements is the likely effect upon competition between FCMs which will be subject to Regulation T requirements only in respect of security futures and broker-dealers which are registered with the SEC pursuant to Section 15(b)(1) of the Exchange Act and which are already fully subject to Regulation T. A full-scale broker-dealer would need to do little, relative to an FCM, to bring itself into compliance with the Proposed Rules. An FCM, by contrast, would have to await the development and implementation of software that adapts its margin and related systems to the requirements of this new regime before it could begin to accept the accounts of customers who are interested in trading security futures.

Subjecting security futures products to the margin account and other provisions of Regulation T also will have an adverse effect on customers that want to trade these products. Futures customers expect to be able to deploy the profits in their accounts, either to establish new positions or to meet margin calls. A customer with unrealized profits ("open trade equity") in its account is permitted to use those profits to satisfy margin requirements arising out of trades and positions in other markets. The Proposed Rules would disallow that practice, but *only with respect to security futures products*.[7] The effect of such a restriction, therefore, would almost certainly be a dampening of customers' interest in security futures.

The separation of account provisions of Regulation T provide generally that the margin requirements for one account may not be satisfied by reference to the items in any other account.[8] The Proposed Rules correspondingly provide that any open trade equity or excess margin deposited in connection with a customer's security futures positions may not be

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7 *See* Proposed CFTC Rule 41.47(a), Proposed SEC Rule 404(a); 66 Fed. Reg. at 50731. Nothing in the text accompanying the Proposed Rules suggests that the Commissions have determined that combining security futures and other futures positions in a single account and permitting them to be margined on a combined basis would be inconsistent with the specific requirements of Section 7(c)(2)(B)(i)-(iv) of the Exchange Act.

8 *See* 12 C.F.R. § 220.3(b) (2001).

considered when the FCM determines whether there is sufficient margin available to support the customer's other futures transactions.

Regulation T permits a limited exception to this prohibition, however. Specifically, positions in commodities, futures contracts and foreign currency may be considered in calculating the margin available for any securities transaction.[9] Thus, Regulation T already permits open trade equity and excess margin deposited in connection with futures positions (other than security futures positions) to be taken into account when determining whether a customer has sufficient margin to support other transactions. Unlike Regulation T, however, the Proposed Rules do not contain such an exception. Thus, if adopted as proposed, the Commissions' proposal is likely to prejudice the ability of FCMs effectively to compete by making it disadvantageous for their customers to trade security futures.

Under the Commissions' companion proposal, a firm that is fully registered as a futures commission merchant and as a broker-dealer would be permitted to choose whether security futures are to be held in a futures account or in a securities account.[10] A firm that is notice-registered would have no such choice – if it is fully registered with the SEC and notice-registered with the CFTC, it would be required to carry security futures in the account established pursuant to SEC Rule 15c3-3; if it is fully registered with the CFTC and notice-registered with the SEC, it would be required to carry security futures in its segregated futures account.[11] If the Commissions adopt our recommended approach, FCMs (*i.e.*, firms that are fully registered with the CFTC but which are notice-registered with the SEC) and dual registrants that choose to carry security futures in a segregated *futures* account would not be subject to the substantive provisions of Regulation T. Conversely, broker-dealers that are fully registered with the SEC but which are notice-registered with the CFTC would be subject to all of the requirements of Regulation T and the Proposed Rules, as would dual registrants that choose to hold security futures positions in a *securities* account.

This alternative approach is fully compliant with the requirements of Section 7(c)(2) of the Exchange Act. Section 7(c)(2)(iv) provides that the margin requirements for security futures, including the type, form and use of collateral, must be and remain consistent with the requirements established by the Federal Reserve Board under Regulation T. As noted earlier, Regulation T currently permits commodity futures contracts to be recorded in the good faith account rather than the margin account. The Commissions, therefore, could reasonably conclude that permitting security futures transactions to be recorded in an account other than the margin

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9 *See* 12 C.F.R. § 220.6(e)(1); Fed. Res. Reg. Ser. 5-650.84, 5-650.85.

10 *See* 66 Fed. Reg. 50786 (October 4, 2001), Securities Exchange Act Release No. 44854 (September 26, 2001).

11 *Id.*

account is "consistent" with Regulation T. We therefore suggest that the Commissions discharge their statutory obligations under the Exchange Act by revising the Proposed Rules to provide that FCMs that hold security futures positions in a futures account will not be subject to the substantive provisions of Regulation T. Making these changes and adopting the other suggestions contained herein will allow the Commissions to satisfy the requirements of Section 7(c)(2) of the Exchange Act in a manner which does not impose undue burdens on FCMs or on customers who desire to trade security futures products.[12] Of equal importance, this approach will ensure that the margin requirements for security futures products and the regulatory costs associated with effecting transactions in these products are effectively comparable for all market participants and will not unfairly favor one segment of the market over another.

IV. <u>The Commissions Should Facilitate the Adoption of Portfolio Margining.</u>

The Commissions have proposed to reduce the 20 per cent margin requirement for customers with offsetting positions involving security futures and one or more related securities or futures contracts.[13] OneChicago supports this proposal to the extent that it would reduce margin requirements based on certain recognized trading strategies, but believes this proposal alone is not sufficient.

Strategy-based offsets are an imprecise method of measuring the risk in a portfolio.[14] By comparison, portfolio margining systems such as TIMS, developed by The Options Clearing

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12 As a statutory matter, a security futures product is both a security and a futures contract. From an operational perspective, however, security futures contracts are identical to other futures contracts and different from other securities. Like other futures contracts (but unlike stocks and other securities), security futures will create continuing, executory obligations on both parties to the contract. Security futures contracts will settle on a T+1 basis, and market participants — whether long or short — will pay or receive daily settlement variation payments. Finally, unlike securities margin, initial and maintenance margin deposited in connection with security futures contracts will serve solely as a performance bond, will not represent a partial payment of the purchase price, and will not be able to be used to fund a customer's delivery obligations.

13 *See* Proposed CFTC Rule 41.45(d), Proposed SEC Rule 402(d). In this regard, we request that the Commissions clarify that the exclusion of security futures from the definition of "margin security," *see* Proposed CFTC Rule 41.47(c), Proposed SEC Rule 404(c), is not intended to preclude margin reductions for the types of offsetting transactions permitted by SRO rules.

14 "[T]he Commissions recognize that the margin levels set forth in the table [setting forth a list of strategy-based offsets that would be presumptively acceptable to the SEC] may not fully reflect the reduction in risk associated with the offsets." 66 Fed. Reg. at 50727.

Corporation ("OCC") and approved for use in respect of clearing member margin requirements, and SPAN, developed by the Chicago Mercantile Exchange and approved for both clearing member *and* customer margin requirements, measure risk more comprehensively and precisely than strategy-based margin offsets. OneChicago endorses the Commissions' decision to facilitate the implementation of portfolio margining.[15] OneChicago accordingly encourages the Commissions to work closely with the SROs to evaluate and expedite the approval of portfolio-based margining systems that can assess the risks associated with complex strategies and positions in multiple markets with greater sophistication and accuracy than strategy-based methods.

OneChicago also is concerned that OCC will not permit margin offsets for any positions that are carried in a segregated futures account. We understand that this refusal is based on the provisions of CFTC Regulations 1.20 and 1.22 which, in general, impose restrictions on the use of customer segregated funds. OneChicago accordingly urges the CFTC to amend Regulations 1.20 and 1.22 or otherwise take steps to ensure the equal treatment of securities and futures accounts.[16]

V. Additional Concerns.

In addition to the concerns addressed above, OneChicago believes that the Proposed Rules also would raise the following concerns for market participants:

A. "Exempted Borrower" Status Should Be Equally Available to FCMs and Broker-Dealers.

Proposed CFTC Rule 41.43(b)(3)(iv)(A) and Proposed SEC Rule 400(b)(3)(iv)(A) would exclude transactions between a creditor and an "exempted borrower" from the margin requirements set forth in the Proposed Rules. Regulation T defines an "exempted borrower" as a member of a national securities exchange or a registered broker or dealer, a substantial portion of whose business consists of transactions with persons other than brokers or dealers, and includes a borrower who: (i) maintains at least 1,000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer; (ii) earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or (iii) earns at least 10 percent

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15 *See* 66 Fed. Reg. at 50724.

16 We note that the CFTC has in the past approved cross-margining programs that permit the commingling of futures and securities positions in a single, segregated funds account, *see* 17 C.F.R. Part 190 Appendix B (Framework 1), and the use of segregated funds to support positions traded on foreign markets. *See* 17 C.F.R. Part 190 Appendix B (Framework 2).

of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer.

It is unclear, however, whether an FCM or floor broker would be permitted for this purpose to include customer accounts or revenues that are not related to security futures products or other securities. In other words, an FCM whose only securities business consists of trading security futures is not likely to qualify as an exempted borrower. A broker-dealer registered under Section 15(b)(1) of the Exchange Act, by contrast, would be far more likely to qualify as an exempted borrower and to be entitled to good faith margin treatment in respect of its security futures positions because of its existing securities activities. To eliminate this disparity, the rules adopted by the Commissions should clarify that the determination of whether an FCM or floor broker is an "exempted borrower" for purposes of security futures will be based upon the FCM's or floor broker's futures market activity.

B. Screen-based Market Makers Should Be Afforded Good Faith Margin Treatment.

The Proposed Rules would permit certain screen-based market markers to be exempt from the margin requirements set forth in these rules. To qualify for this exemption, the Proposed Rules would require such persons: (i) to be registered as floor traders or floor brokers with the CFTC or as dealers with the SEC; (ii) to comply with applicable SEC or CFTC net capital requirements; (iii) to maintain records sufficient to demonstrate compliance with this proposed exclusion; and (iv) to hold themselves out as willing to buy and sell security futures for their own account on a regular or continuous basis.

OneChicago generally supports this exemption as proposed. We nonetheless request that the Commissions confirm that, like option market makers who are exempt from the SEC's net capital rule,[17] registered floor brokers and floor traders will qualify for this exemption even if they are not subject to a net capital requirement under CFTC rules.

C. The Commissions Should Monitor the Effect of SRO Margin Rules.

The futures markets establish margin requirements only for contracts listed for trading on or through their own trading facilities. By contrast, the margin requirements established by the SROs are not limited to the trading facilities operated by these organizations, and Section 7(c)(2)(B)(III)(ii) of the Exchange Act permits a national securities exchange or national securities association to impose margin requirements on security futures which are higher than those required under the rules promulgated by the Commissions. Thus, it is possible for the SROs to impose additional margin requirements for security futures on their members even if these contracts are not being traded through their facilities. Any such rules are subject to the

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17 *See* Exchange Act Rule 15c3-1(b)(1).

requirements of Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, which prohibit an SRO from adopting any rules which impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. OneChicago accordingly urges the Commissions to monitor the adoption, interpretation and enforcement of margin rules by the SROs and the contract markets to ensure that they do not unreasonably inhibit the development of security futures markets.

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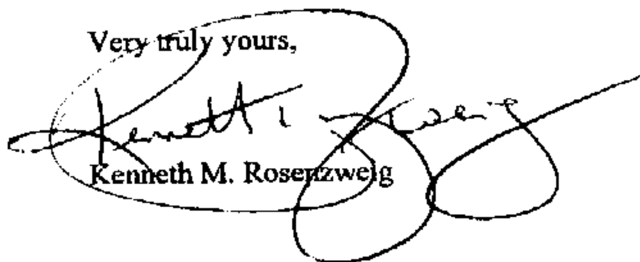
OneChicago appreciates the opportunity to comment on the Proposed Rules and would be pleased to work with the CFTC and SEC staffs and other interested parties to address the issues discussed herein. Please do not hesitate to contact the undersigned, as counsel to OneChicago, at 312-701-8354, if we can answer any questions or otherwise be of assistance to the Commissions as they address this important subject.

Very truly yours,



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