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AMERICAN STOCK EXCHANGE®
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December 7, 2001

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OFC. OF THE SECRETARIAT

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

COMMENT

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C.F.T.C.

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:

By letter dated December 5, 2001, the American Stock Exchange ("Amex" or "Exchange") commented on the above captioned matter together with the Chicago Board Options Exchange, The Options Clearing Corporation, the International Securities Exchange, the Pacific Exchange, and the Philadelphia Stock Exchange (the "Coalition Letter"). For the reasons stated in the Coalition Letter, the Amex supports the proposed rules and urges the Commissions to adopt final rules in substantially the same form as proposed. The Amex submits this letter for the sole purpose of commenting upon the proper criteria for determining who is a security futures market maker on a screen-based exchange.[1]

The Amex generally agrees with the criteria for determining who is eligible for market maker treatment set forth in the proposed rules.[2] We believe, however, that

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1 The Coalition Letter notes that some signatories have different views on the proper criteria for determining who is a market maker on a screen-based exchange and consequently may submit separate comment letters on this issue.

2 Proposed SEA Rule §242.400(b)(3)(iv)(C) and proposed CFTC Rule §41.43(b)(3)(iv)(C) provide:

> This part does not apply to:
> (iv) Credit extended, maintained, or arranged by a creditor to or for a member of a national securities exchange or a registered broker or dealer if:...
> (C) The borrower is a member of a national securities exchange or a national securities association registered under Section 15A(a) of the Exchange Act (15 U.S.C. 78o-3(a)) and the borrower:

proposed subsection (iv) which, "require[s] such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis," could be further refined so that only those members of an electronic exchange that (1) have a continuous affirmative obligation to quote a two-sided market, or (2) effect more than two-thirds of their security futures trades on that exchange with persons other than registered market makers on that exchange, would be deemed market makers for purposes of that exchange's security futures.

Discussion

Under the proposed rules, market makers in security futures would be exempt from the customer margin rules and would be eligible for "good faith" financing by their clearing agents. Persons designated as market makers, accordingly, would have a significant competitive advantage relative to persons that are not so designated.

We believe that identifying bona fide market makers (as opposed to active traders) in a screen-based market is different than identifying market makers on a traditional, limited access, floor-based exchange, due to the possibility in a screen-based market of unlimited access and inexpensive memberships. The Federal Reserve acknowledged the difficulty of identifying market makers in an electronic exchange in its delegation of authority to the Commissions to set customer margin requirements. The Board wrote: "The Board expects to have further discussions with the Commissions to identify the conditions under which floor traders would act as market makers in an electronic trading environment."[3]

As noted in the Coalition Letter, the Commodity Futures Modernization Act attempts to create virtually identical regulatory treatment for exchange traded options and security futures in core regulatory areas (including margin) in order to eliminate regulatory disparities that would create artificial competitive inequities between these

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(1) Does not directly or indirectly accept or solicit orders from any customer or provide advice to any customer in connection with the trading of security futures; and
(2) Is registered with such exchange or such association as a security futures dealer, pursuant to regulatory authority rules that have become effective in accordance with Section 19(b)(2) of the Exchange Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the Act (7 U.S.C. 7a-2(c)), that:
(i) Require such member to be registered as a floor trader or a floor broker with the CFTC under Section 4f(a)(1) of the Act (7 U.S.C. 6f(a)(1)), or as a dealer with the SEC under Section 15(b) of the Exchange Act (15 U.S.C. 78o(b));
(ii) Require such member to comply with applicable SEC or CFTC net capital requirements; (iii) Require such member to maintain records sufficient to prove compliance with this paragraph and the rules of the exchange or association of which the borrower is a member;
(iv) Require such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis; and
(v) Provide for disciplinary action, including revocation of such member's registration as a security futures dealer, for such member's failure to comply with §§41.43 through 41.48 or the rules of the exchange or association.

[3] *See*, letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to Mr. James E. Newsom, Acting Chairman, CFTC and Ms. Laura Unger, Acting Chairman, SEC, March 6, 2001.

similar products.[4] We believe that this principle of the CFMA reasonably should be extended to defining the responsibilities of persons that seek market maker status in security futures on electronic exchanges. We are concerned that if the Commissions were to establish lower standards for market makers on electronic exchanges, there would be an incentive for market makers on traditional securities markets to migrate to exchanges where they would have fewer responsibilities but the same regulatory advantages as market makers on traditional exchanges.

Options market makers[5] currently are obligated by exchange rules to contribute liquidity and to otherwise conduct their trading in ways that benefit the market as a whole. Options market makers have affirmative obligations to engage in a course of trading that is reasonably calculated to contribute to the maintenance of a fair and orderly market.[6] They also have a continuous obligation to engage in transactions for their account, to a reasonable degree under the circumstances, when there exists a lack of price continuity, a temporary disparity between supply and demand for a particular option contract, or a temporary distortion of the price relationships among option contracts of the same class.[7] Options market makers also are subject to negative obligations under exchange rules that prohibit them from entering into transactions that are inconsistent with the maintenance of a fair and orderly market.[8]

In carrying out their affirmative responsibilities, market makers are obligated to make continuous, two-sided markets. Market makers carry out this obligation primarily by quoting both a bid and ask for an option. When a market maker provides these quotes, the market maker does not always know whether the person requesting the quotes wishes to buy or sell the options in question. The market maker's quotes are "firm" for a certain minimum number of contracts or for a specified size.

Because of their obligations to make continuous, two-sided markets, market-makers perform a function that is not performed by other participants in the options markets. Other participants, including active traders, are free to stop trading whenever they wish, and may be expected to do so at times of market stress. Market makers, on the other hand, are obligated to provide liquidity under all conditions. In addition, active traders can be viewed as "taking" rather than "making" liquidity to the extent that they hit bids and take offers. In contrast, options market makers provide liquidity by quoting both a bid and ask price and standing ready to take the other side of whatever position the other party wishes to take. The options exchanges monitor the performance of market makers to ensure that they carry out their responsibilities. Market makers who are found

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[4] *See*, the authorities cited on page 2 of the Coalition Letter.

[5] Options market makers include market makers with primary responsibilities, who are called specialists on the Amex, and auxiliary market makers, known as registered options traders on the Amex.

[6] *See, e.g.*, Amex Rule 170(b) made applicable to options by Rule 950(n), and Amex Rule 958(b).

[7] *See e.g.*, Amex Rule 170(d) made applicable to options by Rule 950(n), and Amex Rule 958(c).

[8] *See, e.g.*, Amex Rule 170(c) made applicable to options by Rule 950(n) and Amex Rule 958(b).

to have violated exchange rules are subject to sanctions. To facilitate and encourage market making, options market makers have received specified regulatory relief such as an exemption for Securities Exchange Act Section 11(a) and "good faith" margin treatment.

The Exchange has observed that options market makers on the Amex trade with one another infrequently. That is, options market makers almost always take the other side of customer and broker-dealer orders originating from off the Floor of the Exchange rather than trading among themselves. In trading in this manner, options market makers are supplying liquidity to the market in an observable and verifiable manner. We believe that this feature of the way that bona fide options market makers operate could be developed into a test for identifying persons that are bona fide liquidity providers in an electronic market.

We are proposing alternative tests for identifying a person that satisfies the statutory definition of a market maker in the context of an electronic market for security futures. Under our proposal, only those members of an electronic exchange that meet all of the proposed requirements for market maker status[9] and that (1) have a continuous affirmative obligation to quote a two-sided market, or (2) effect more than two-thirds of their security futures trades on that exchange with persons other than registered market makers on that exchange, would be deemed to be market makers on that exchange. We believe that this approach is consistent both with the statutory definition of a market maker, *i.e.*, a person that holds himself out as being willing to buy and sell security for his own account on a regular and continuous basis, and with the margin requirements of Section 7 of the Securities Exchange Act. (Section 7(c)(3)(A) of the Securities Exchange Act exempts from margin requirements 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.") Our proposal reasonably extends to market makers the logic of Section 7(c)(3)(A) of the Exchange Act, which exempts exchange members and broker-dealers from margin requirements if "a substantial portion of [their] business consists of transactions with persons other than brokers or dealers," by basing the market maker exemption on their effecting a substantial portion of their trades with persons other than registered market makers on their market. Our proposal also would give an electronic security futures exchange two methods to obtain market maker status for those of its members that wish it: (1) the exchange could adopt rules imposing obligations on its market makers similar to those on options market makers, or (2) the exchange could adopt rules or enforce Commission standards requiring its market makers to effect a substantial portion (*i.e.*, more than two-thirds) of their trades on that exchange with non-market makers on that exchange.

Market makers on options exchanges have specified responsibilities and receive regulatory relief from rules applicable to other persons so that they may fulfill their responsibilities. We believe that it is inconsistent with the statutory scheme of the CFMA to apply different requirements to market makers in security options and security futures and we see no reason to establish a new regulatory scheme for market makers in a new

[9] *See*, footnote 2 above.

class of security. In the Exchange's view, persons that wish to obtain the benefits of market maker status should shoulder the responsibilities of market makers; active traders that trade opportunistically and take liquidity from the market should not have market maker status. Market makers in a screen-based securities futures market, therefore, either should have an enforceable obligation to provide liquidity or they should meet an objective standard for supplying liquidity.

We would be please to provide further information to the Commissions or their staffs regarding our views on this issue.

Very truly yours,

Michael J Ryan Jr.

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