Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
NASDAQ Options Market
NASDAQ OMX PHLX
The Options Clearing Corporation

U.S. Commodity Futures Trading Commission
David Stawick
Office of the Secretary
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

U.S. Securities and Exchange Commission
Elizabeth Murphy
Office of the Secretary
100 F Street, NE
Washington, DC 20549

September 18, 2009

RE: File No. 4-588, SEC-CFTC Joint Meetings

Dear Ms. Murphy and Mr. Stawick:

The Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, and The Options Clearing Corporation ("the Options Exchanges") appreciate the opportunity to comment on the joint regulatory harmonization initiative of the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"). The SEC and the CFTC held joint meetings on September 2 and 3, 2009, to seek input from the public on harmonization of market regulation. These meetings provided the agencies with valuable recommendations for changes to their statutes and regulations that would eliminate regulatory differences with respect to similar types of financial instruments. The meetings stem from a recommendation by the Administration that the two agencies work together to harmonize the regulation of futures and securities. The Options Exchanges commend the CFTC and SEC for acting promptly to begin this important initiative.

This comment letter provides a high level overview of the key differences between regulation of securities markets by the SEC and regulation of futures markets by the CFTC, the impact of the disparities on markets and investors, and possible approaches to harmonize the differing regulatory structures. There are a number of differences arising from the separate governing statutes of the securities and futures markets. The letter does not attempt to cover all the specific legal areas in need of reconciliation, but rather focuses on the major disparities that would need to be addressed in a true harmonization of the regulatory treatment of the securities and futures markets. The letter concentrates on the disparities between the regulation of stock index futures and that of equity securities such as stock index options, equity options and individual stocks.

1. Margin. Differences in approach to margin between the SEC and CFTC are one of the areas with the largest effect on competition between the securities and futures markets as well as on systemic risk. Futures markets set margin levels without real CFTC involvement. In contrast, initial stock margin is set by the Federal Reserve and the SEC and equity options margin level, while proposed by the exchanges, must be approved by the SEC. The result is that futures margin levels consistently have been much lower than margin required

in the securities markets (except for security futures, which are jointly regulated by the SEC and CFTC). For example, stock index futures margin usually involves 5% or less of the contract value, yet for stock index options, purchasers must generally pay the full purchase price while sellers must put up margin equal to the premium received plus 15%-20% of the index value. There are other areas of more lenient treatment of margin for futures products as opposed to equivalent securities products, such as the type of collateral posted for margin and the instruments permitted to act as margin offsets.

The differences in margin levels have a significant competitive impact. As margin controls the amount of leverage in a product, the lower margin levels for futures give the product a cost advantage over options that is not justified by differences in the risks presented by the products. In addition, leaving the establishment of futures margin levels completely to the futures exchanges has resulted on occasion in very low stock index futures margin. This poses substantial competitive disparities in regard to stock index options. To resolve the margin disparity, all equity derivatives margin should be subject to the same standards and process of oversight.

Another margin issue arising from different regulatory systems for futures and securities is the stalemate over portfolio margining. In 2007, the availability of portfolio margining was greatly enhanced for securities customers, including those who trade security futures, through expansion of an existing portfolio margin pilot program approved by the SEC. This expanded pilot includes equity options, security futures and individual stocks as instruments eligible for portfolio margining. The pilot enhances U.S. competitiveness by bringing the benefits of risk-based margining employed in the futures markets, and in most non-U.S. securities markets, to U.S. securities customers. The exchange rules adopting this pilot also authorized the inclusion of related futures positions in securities customer portfolio margining accounts.

The ability to margin all related instruments in one account would allow customers to fully realize the risk management potential of these instruments in a way that is operationally and economically efficient. However, provisions in the futures laws that prevent full cross margining of securities and futures products and that complicate the placement of futures positions in a securities customer portfolio margining account significantly undercut the ability of customers to fully realize the capital efficiencies of portfolio margining. For over four years, the SEC and CFTC have been unable to agree on how to permit futures to be included in a securities portfolio margin account. Because the two agencies continue to disagree on the most appropriate approach to implementing portfolio margining, the ability of many customers to employ portfolio margining between futures and securities has been stymied. Unless this deadlock is broken, portfolio margining will not reach its full potential in the United States, even though it is used in many jurisdictions abroad. As a first step in resolving this disparity, Congress would need to amend the Securities Investor Protection Act ("SIPA") to allow broad-based index futures to be treated as securities when included in an SEC-regulated portfolio margining account. The CFTC would then need to provide an exemption from the segregation requirements of the Commodity Exchange Act ("CEA") for futures positions held in a securities customer's portfolio margining account. Another step would be for the CFTC to permit a portfolio margin account to be established using the "one pot" clearing method utilized in the securities markets. Many participants at the joint hearings urged the CFTC to take these steps. It would be a true indication of the CFTC's commitment to harmonization were it to do so.

2. Principles-Based vs. Rules-Based Approach. When the CEA was amended by the Commodity Futures Modernization Act of 2000, it established a "principles-based" regulatory approach for exchanges and clearing organizations under CFTC jurisdiction. The CEA sets forth separate sets of "core principles" for exchanges and clearing organizations. While all futures exchanges and clearing organizations must adhere to the core principles applicable to them, they are given considerable discretion in determining how they will do so. In contrast, securities exchanges and clearing organizations are subject to a "rules-based" regulatory approach under the securities laws and SEC regulations in which they are required to comply with specific and prescriptive regulations. This results in regulatory inefficiencies because the SEC does not have the flexibility to differentiate or prioritize its review of SRO rules based on their systemic importance. For example, in some cases, exchanges must file to list new products that have already been approved by the SEC for trading on a competing exchange. When reviewing the filing, the SEC must use the same checklist approach to approval regardless of its previous review potentially resulting in delays before these products can trade even though there is no systemic impact from listing the product in competing venues. To resolve this disparity, the SEC should seriously explore how to move closer to a principles-based approach for exchanges and clearing organizations under its jurisdiction.

3. Oversight of Self-Regulatory Organizations ("SROs"). A prime example of these different regulatory approaches is how the CFTC and SEC oversee the SROs under their respective jurisdictions. The CFTC employs a risk-based approach to oversight of SROs, where it sets regulatory objectives for regulated entities and focuses its attention on areas offering the most risk. Under this approach, SROs are free to establish or change their own rules with the requirement only that they certify with the CFTC that the proposed rule change is in compliance with the CEA. Upon receipt of a self-certification, the CFTC can decide whether or not to conduct a full review of the proposal. This structure enables SROs to implement business decisions promptly yet permits the CFTC to concentrate on proposals that present significant regulatory issues. In contrast, the SEC follows a mechanical rules-based approach, with the production of very specific market rules and a prosecutorial orientation on failures to comply with detailed rules. As a result, the SEC employs an outdated structure where the majority of proposed SRO rules changes are automatically subject to an extensive SEC review. The differences in the review process significantly disadvantage securities SROs in three ways. First,

they often cause substantial delay for securities SROs in introducing new products. While futures SROs can start trading a new product very quickly through a certification process, many new securities products have to undergo an SEC review process that can take months, and in some cases over a year. Second, in a like manner, securities SROs are delayed by the rule change review process in making changes to operations. Third, securities SROs can be subject to ad hoc standards imposed through the SEC review process.

This disparity poses severe competitive disadvantages to securities SROs and inhibits innovation in the securities markets. The best way to harmonize the two approaches is for the SEC to adopt a process for handling SRO rule changes that resembles the CFTC certification process. The SEC approach wastes government and industry resources without regulatory benefits; moving in the direction of the CFTC certification process presents a more efficient alternative.

4. <u>Customer Protection and Market Integrity</u>. There are several areas where the securities laws are more vigorous than the futures laws in promoting customer protection and market integrity. First, the securities laws contain strong prohibitions against corporate insiders trading on the basis of material, non-public information. The CEA does not prohibit insider trading even on securities-based futures other than security futures. Second, the securities laws and SRO rules impose suitability requirements on broker-dealers making recommendations to customers. These include heightened suitability standards for options transactions. The CFTC does not impose a suitability requirement, nor do the futures exchanges or NFA, except for security futures. There is no legitimate policy reason to apply disparate insider trading and suitability rules on securities-based futures as opposed to securities themselves. To resolve this disparity, the futures laws should be strengthened along the lines of the provisions applying to securities options.

5. <u>Bankruptcy and Insolvency</u>. The securities and futures laws differ on the procedures for handling broker insolvencies. The securities laws generally require brokers to join the Securities Investor Protection Corporation ("SIPC"), which assesses its members to create a fund to be used in case of a broker insolvency. The fund reimburses customer losses up to a certain limit. In addition, the SEC's customer protection rules require brokers (a) to have physical possession or control of all "fully-paid securities" and "excess margin securities" carried for customer accounts and (b) to maintain a "Special Reserve Bank Account" for the exclusive benefit of customers in which the broker must maintain an amount of funds calculated pursuant to a formula specified in SEC rules.

The CEA does not provide for SIPC-type insurance protection for futures customers. The CEA does require strict segregation of customer funds from the funds of the futures commission merchant ("FCM") holding the account. The customer funds must be held in a separate bank account that is clearly designated as belonging to customers. This ensures (1) that the FCM does not commingle customer funds with its own funds and (2) that in the event of an

FCM bankruptcy, customer funds would be identified as such and would not be available to other creditors of the FCM.

Broker-dealers are required to be liquidated pursuant to SIPA and SIPC's rules regulations. FCMS are required to be liquidated pursuant to a special subchapter of the Bankruptcy Code and the bankruptcy rules of the CFTC. This disparity results in conflicting insolvency approaches for an entity that is both a broker-dealer and a futures commission merchant. In harmonizing the futures and securities laws, attention should be given to whether the bankruptcy structures should be continue to be so dramatically different for securities and futures products. If the two separate structures are kept in place, then attention should be given to how best to reconcile the differences when a dual broker-dealer/FCM becomes insolvent.

6. New Product Legal Status. Split jurisdiction between the SEC and CFTC and their different governing statutes creates legal uncertainties, as a novel aspect of a new securities derivatives product could cause the CFTC to claim that the product has elements of a futures product, and a novel aspect of a new futures product could cause the SEC to claim that the product is a security. This frequently has resulted in a very long delay in bringing a new derivatives product to market while the two agencies try to decide who has jurisdiction over the instrument. The only certain way to eliminate this problem is to consolidate the agencies. Short of that solution, however, a means to provide some relief would be to establish a mechanism so that regulatory status disputes could be brought to the Treasury Department for resolution.

Conclusion

The joint hearings provide the two agencies with a golden opportunity to break historic stalemates over jurisdictional issues and to move toward a more rational regulatory structure of treating equivalent products in an equivalent regulatory manner. We hope that the two agencies display a willingness to abandon traditional positions in order to move toward a true harmonization of futures and securities regulation. We would be happy to discuss further any of the issues raised in this letter. Should you have any questions, please contact Susan Milligan of the Options Clearing Corporation at (212) 756-1972 or outside counsel Howard Kramer at (202) 778-6414.

Sincerely,

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International Securities Exchange
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cc: SEC Commissioners
CFTC Commissioners