Dechert
LLP

1775 I Street, N.W.
Washington, DC 20006-2401
+1 202 261 3300 Main
+1 202 261 3333 Fax
www.dechert.com

STUART J. KASWELL

stuart.kaswell@dechert.com
+1 202 261 3314 Direct
+1 202 261 3333 Fax

May 10, 2006

SUBMITTED ELECTRONICALLY

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number SR-CBOE-2006-14
File Number SR-NYSE-2006-13

Dear Ms. Morris:

On behalf of our client, Federated Investors, Inc. ("Federated")[1], we are pleased to comment on these two proposed rule changes regarding expanding portfolio margin submitted by the Chicago Board Options Exchange ("CBOE") and the New York Stock Exchange ("NYSE") (sometimes referred to as the "Exchanges"). Federated commends the Securities and Exchange Commission (the "Commission" or the "SEC"); other regulators; the Exchanges; as well as other interested self-regulatory organizations ("SROs"), such as the Options Clearing Corporation (the "OCC"), and the NASD; the Securities Industry Association ("SIA") and its member firms; and all other involved parties for this collaborative effort to develop workable portfolio margining mechanisms.

1 Federated is one of the top ten mutual fund companies in America and is a member of the S&P 500 Index of leading companies. Federated has more than $213 billion in assets under management; nearly $30 billion of which are in equity assets. Federated is one of the largest institutional money market fund managers, and is in the top two percent of money market fund managers, top six percent of fixed income fund managers, and top seven percent of equity fund managers. Federated has approximately 170 wholesalers serving 5,500 clients including many of the world's largest banks, broker-dealers, insurance companies, corporations, and government entities.

Federated believes that portfolio margining is in furtherance of the interests of investors because it reduces risk and lowers costs.

Federated is commenting on these proposed rule changes because it believes that the Exchanges and the Commission should make clear that broker-dealers and futures commissions merchants ("FCMs"), and their customers should be able to use shares in money market funds ("MMFs") as collateral for portfolio margin. We believe that the current portfolio margin rules implicitly or explicitly permit MMF shares for margin; nonetheless, we believe that the proposals should make clear that a customer, broker-dealer, or FCM can use MMF shares for portfolio margin.[2]

Background

Regulation T

Broker-dealers may use MMFs for margin in appropriate circumstances under Regulation T (Credit by Brokers and Dealers). The Board of Governors of the Federal Reserve System ("the Board") has adopted 12 CFR § 220.12, which establishes the initial margin requirements for most securities. As defined in 12 CFR § 220.2, "Margin deficiency" means "the amount by which the required margin exceeds the equity in the margin account." In addition, 12 CFR § 220.4(c)(2) ("Satisfaction of deficiency") provides that "the additional required margin may be satisfied by a transfer from the special memorandum account or by a deposit of cash, margin securities, exempted securities, or any combination thereof." It further includes in the definition of "Margin security":

> (4) Any security issued by either an open-end investment company or unit investment trust which is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8)….

Regulation T provides that a "*Money market mutual fund* means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940

---

2 We also seek clarifications from the Commission and the Exchanges with regard to possible concerns under Section 11(d)(1) of the Securities Exchange Act of 1934 (the "Exchange Act").

(15 U.S.C. 80a-8) that is considered a money market fund under SEC Rule 2a-7 (17 CFR 270.2a-7)."[3] Accordingly, for Regulation T purposes, a broker-dealer may accept securities in one or more MMFs to satisfy a margin deficiency. Of course, Federated recognizes that in many instances, it would be more advantageous for a customer with a margin deficiency to deposit cash in an account, rather than depositing MMF shares, since the former reduces the interest costs that a customer must pay to the broker-dealer extending the credit.[4] Nonetheless, there may be instances, which Regulation T clearly contemplates, in which a customer may provide shares in a MMF to satisfy a margin deficiency. For example, 12 CFR § 220.4(b)(4)(ii) provides that "when a security held in the account serves in lieu of the required margin for a short call, the security shall be valued at no greater than the exercise price of the short call."[5]

In addition, we note that in 1996, the Board eased Regulation T's treatment of margin with regard to the purchase of MMFs by affording them "good faith" treatment.[6] Similarly, the Board amended the definition of "cash equivalent" to include MMFs,

---

3 12 CFR § 220.2.

4 We understand that if a customer is borrowing money from a broker-dealer on margin and is paying more in interest than he or she is earning from an investment in another security, such circumstances are referred to as a "negative spread." Federated is opposed to knowingly using MMFs (or any of its products) in a way that would disadvantage or harm investors. Federated also would support disclosure to customers alerting them to this concern.

5 *See* discussion *infra* regarding performance bond versus extensions of credit.

6 12 CFR § 220.12(b) (Supplement) provides that:

> The required margin for each security position held in a margin account shall be as follows:
> ****
> (b) Exempted security, non-equity security, money market mutual fund or exempted securities mutual fund: The margin required by the creditor in good faith or the percentage set by the regulatory authority where the trade occurs, whichever is greater.

Regulation T; Docket No. R—0772 (Apr. 24, 1996); 61 FR 20386 (May 6, 1996). The Board notes that it adopted "amendments regarding the loan value of securities include changing the loan value of money market and exempted securities mutual funds from 50 percent to 'good faith' loan value." *Id.*

allowing them to cover puts in a cash account.[7] In 1997, the Board also made corresponding changes to Regulation U.[8] The Board "amended the definition of 'margin stock' in Regulation U to exclude money market mutual funds. This will have the effect of permitting good faith loan value for these securities when they are used as collateral for a purpose loan that is secured in part by margin stock."[9] In our view, these provisions

---

7 12 CFR § 220.8(a) provides that:

> In a cash account, a creditor may:
> ***
> (4) Use an escrow agreement in lieu of the cash, cash equivalents or underlying asset position if:
>
> (i) In the case of a short call or a short put, the creditor is advised by the customer that the required securities, assets or cash are held by a person authorized to issue an escrow agreement and the creditor independently verifies that the appropriate escrow agreement will be delivered by the person promptly; or
>
> (ii) In the case of a call issued, endorsed, guaranteed, or sold on the same day the underlying asset is purchased in the account and the underlying asset is to be delivered to a person authorized to issue an escrow agreement, the creditor verifies that the appropriate escrow agreement will be delivered by the person promptly.

The amendment of 12 CFR § 220.2 provides that:

> *Cash equivalent* means securities issued or guaranteed by the United States or its agencies, negotiable bank certificates of deposit, bankers acceptances issued by banking institutions in the United States and payable in the United States, or money market mutual funds.

8 Regulation U (Credit by Banks and Persons Other than Brokers and Dealers for the Purpose of Purchasing or Carrying Margin Stock).

9 Regulations G, T, U, and X; Docket Nos. R-0905, R-0923, and R-0944 (Dec. 18, 1998) [date must be 1997, since effective date was April 1, 1998] at 30 (hereinafter referred to as the "1997 Amendments"). *See also* Federal Register version of the 1997 Amendments, dated Jan. 8, 1998; 63 FR 2806 (Jan. 16, 1998).

Footnote 64 to the 1997 Amendments states that:

demonstrate the Board's confidence in the quality of the Commission's regulation of MMFs under Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act")[10] and in the stability that MMFs have demonstrated over many years.

New Issues and Extensions of Credit

Section 11(d) of the Exchange Act prohibits a broker-dealer from extending credit for the purchase of a new issue of securities.[11] The Commission has adopted Rule 11d1-2 under the Exchange Act, which provides that:

> Regulation T was amended last year [*i.e*., 1996] to provide similar treatment for money market mutual funds. The Board is using the same definition used at that time, i.e., a security issued by a registered investment company that is considered a money market fund under SEC Rule 2a-7 (17 CFR 270.2a-7, "Money market funds").

We discuss that amendment *supra*.

10 *See* Elliott R. Curzon, *Margin and Extensions of Credit: An Overview,* in Clifford E. Kirsch, Broker-Dealer Regulation (2004). *See also* 12 CFR § 220.18 (time payment for mutual fund shares purchased in a special cash account).

11 Section 11(d)(1) of the Exchange Act provides that:

> It shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction: *Provided*, That credit shall not be deemed extended by reason of a bona fide delayed delivery of (i) any such security against full payment of the entire purchase price thereof upon such delivery within thirty-five days after such purchase or (ii) any mortgage related security or any small business related security against full payment of the entire purchase price thereof upon such delivery within one hundred and eighty days after such purchase, or within such shorter period as the Commission may prescribe by rule or regulation....

> Any securities issued by a registered open-end investment company or unit investment trust as defined in the Investment Company Act of 1940 shall be exempted from the provisions of section 11(d)(1) with respect to any transaction by a person who is a broker and a dealer who, directly or indirectly, extends or maintains or arranges for the extension or maintenance of credit on such security, provided such security has been owned by the person to whom credit would be provided for more than 30 days, or purchased by such person pursuant to a plan for the automatic reinvestment of the dividends of such company or trust.[12]

We discuss this issue below in conjunction with our request.

SRO Margin Rules

For many years, SROs, such as the NYSE, have adopted their own margin rules in addition to Regulation T. The Board's margin rules under 12 CFR § 220.1(2) provide that "this part does not preclude any exchange, national securities association, or creditor from imposing additional requirements or taking action for its own protection." For example, NYSE Rule 431 governs both initial margin and maintenance margin.[13] Again, it has been our understanding that under NYSE rules, MMFs are an acceptable form of margin.[14]

---

12 Rel. 34-21577 (Dec. 18, 1984); [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶83,720. The Commission adopted the rule after the Board "amended Regulation T, effective November 3, 1980, to include fund securities which have loan value for margin accounts," citing 12 CFR § 220.2(o). The Commission notes that commentators unanimously supported the proposal and some suggested deleting the thirty day holding period. Because of concerns about potential abuse, the Commission declined to accept suggestions that it delete the thirty day requirement. However, the Commission determined to monitor the effects of the 30-day aspect of the rule. *Id*. at p. 87,207.

We note that the rule applies to all registered open-end investment companies and unit investment trusts, and not just to MMFs. Presumably, the risks of sales practice abuse are substantially reduced with MMFs. *See* discussion *infra.*

13 *See* also NASD Rule 2520. Broker-dealers may have their own "house" margin as well.

14 NYSE Rule 431(f)(1).

We also appreciate that margin may serve different purposes in different settings. Loss and Seligman explain:

> Options margin requirements are different. Options may not be *bought* on credit, but they may be *sold* (or written) by the use of margin. Unlike stock purchases where margin finances a credit transaction, options margin is a type of performance bond for the possible obligations incurred if the underlying stock generates a loss for the options writer. The Federal Reserve Board has delegated the setting of both initial and maintenance margin to the options exchanges.[15]

In this context, it is our understanding that MMFs are an acceptable form of margin under CBOE Rule 12. For example:

> CBOE Rule 12.3(d) Customer Cash Account -- Short Options, Stock Index Warrants, Currency Index Warrants and Currency Warrants.
>
> (1) *Equity Options.*
>
> (B) *Puts.* A put option contract carried in a short position is deemed a covered position, and eligible for the cash account, provided any one of the following offsets is either

---

> **Determination of Value for Margin Purposes.—**Active securities dealt in on a national securities exchange shall, for margin purposes, be valued at current market prices. Other securities shall be valued conservatively in view of current market prices and the amount which might be realized upon liquidation. Substantial additional margin must be required in all cases where the securities carried in "long" or "short" positions are subject to unusually rapid or violent changes in value, or do not have an active market on a national securities exchange, or where the amount carried is such that the position(s) cannot be liquidated promptly.

In its discussion of NYSE margin, Loss and Seligman, Securities Regulation, 3rd Edition ("Loss and Seligman") explains the NYSE's initial and maintenance margin requirements. In an example of maintenance margin, Loss and Seligman notes that a customer may cure a margin deficiency by depositing either cash or securities. Loss and Seligman at § 8-B-4(j) (3d ed. Supp. 2005).

15 *Id*.

> held in the account at the time the put is written or is received into the account promptly thereafter:
> (1) cash or cash equivalents in an amount not less than the aggregate exercise price....

CBOE Rule 12.3(12) provides that the "term 'cash equivalent' is as defined in Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System." As indicated at note 7, *supra*, the Board's definition of "cash equivalent" includes MMFs.

With the advent of security futures, the NYSE and other SROs adopted special margin rules for that product, an example of which is NYSE Rule 431(f)(10). NYSE Rule 431 Supplementary Material provides that:

> **.70** Money market mutual funds, as defined under Rule 2a-7 of the Investment Company Act of 1940, can be used for satisfying margin requirements under this subsection (f)(10), provided that the requirements of Rule 404(b) of the Exchange Act and Rule 46(b)(2) under the CEA [Commodity Exchange Act] are satisfied.[16]

Portfolio Margining

In our view, MMFs should be able to qualify as margin security eligible to meet the margin requirements under the Exchanges' proposed rules.

---

16 *See also* NASD Rule 2520(g)(1). In addition, CBOE Rule 12.11 provides:

Compliance with Margin Requirements of New York Stock Exchange

> In lieu of meeting the margin requirements set forth in Rules 12.3 through 12.9 of this Chapter and margin rules in other chapters, a Member Organization that is a member of the New York Stock Exchange may elect to be bound by the initial and maintenance requirements of the New York Stock Exchange as the same may be in effect from time to time. Such election shall be made in writing by a notice filed with the Exchange and shall remain effective until the Member Organization shall file with the Exchange a written notice of revocation. Upon the filing of such election, a Member Organization shall be bound to comply with the margin rules of the New York Stock Exchange as though such rules were part of these Rules.

CBOE Proposal

On January 15, 2002, the CBOE submitted a proposal:

> to amend its rules, for certain customer accounts, to allow member organizations to margin listed, broad-based, market index options, index warrants and related exchange-traded funds according to a portfolio margin methodology as an alternative to the current strategy-based margin methodology. The proposed rule change will also provide for cross-margining by allowing broad-based index futures and options on such futures to be included with listed, broad-based index options, index warrants and related exchange-traded funds for portfolio margin treatment.[17]

After filing two amendments, the SEC approved the CBOE's proposal for a two-year pilot program.[18]

NYSE Proposal

On May 13, 2002, the NYSE submitted a similar proposal to allow member organizations to margin listed, broad-based, market-index options, index warrants, futures, futures options and related exchange-traded funds according to a portfolio margin

---

17 SR-CBOE-2002-03; Rel. 34-45630 (Mar. 22, 2002), 67 FR 15263 (Mar. 29, 2002).

18 SR-CBOE-2002-03; Rel. 34-52032 (July 14, 2005) ("CBOE Adopting Release"). The CBOE Adopting Release explains at note 5 that:

> The CBOE proposed Amendment No. 1 to make corrections or clarifications to the proposed rule, or to reconcile differences between the proposed rule and a parallel filing by the NYSE. See Securities Exchange Act Release No. 46576 (October 1, 2002), 67 FR 62843 (October 8, 2002) (File No. SR-NYSE-2002-19).

At note 8, the Commission explains Amendment No. 2:

> The [CBOE] submitted this partial amendment, pursuant to the request of Commission staff, to remove the paragraph under which any affiliate of a self-clearing member organization could participate in portfolio margining, without being subject to the $5 million equity requirement.

methodology. After amending the proposal three times, the Commission approved it on July 14, 2005.[19]

OCC Proposal

The OCC also filed a proposed rule change to facilitate portfolio margining. In the Approval Order for the CBOE's proposal, the Commission notes that "the OCC will compute clearing house margin for the broker-dealer using the same portfolio margin methodology applied at the customer level. The OCC will continue to require full payment for all customer long option positions."[20] The OCC proposed a rule that created a single "customer's lien account" to clear all transactions of eligible customers under the portfolio or cross-margining program. The OCC has a lien on all positions and assets in the customer's lien account as security for the OCC clearing member's obligation relating to the account. The Commission approved the proposal for the new account.[21] The Commission Staff also granted no-action relief to the OCC in conjunction with the new account.[22]

Additional Proposals

On September 27, 2005, SEC Chairman Christopher Cox wrote to William Brodsky, Chief Executive Officer ("CEO") of the CBOE and to John A. Thain, CEO of the NYSE, requesting that they file proposed rule changes to expand portfolio margin to equity options and security futures by the end of 2005.

December 2005 NYSE Proposal

---

19 SR-NYSE-2002-19; Rel. 34-52031 (July 14, 2005) (the "NYSE Adopting Release").

20 CBOE Adopting Release at 8.

21 SR-OCC-2003-04; Rel. 34-52030 (July 14, 2005); 70 FR 42405 (July 22, 2005) (the "OCC Approval Order").

22 OCC Approval order at note 6.

On December 29, 2005, the NYSE filed a proposed rule change in response to that request.[23] The proposed amendments would expand the eligible products to include security futures as well as listed single stock options.[24]

Current Proposals[25]

NYSE March 2006 Proposal

On March 2, 2006, the NYSE filed a separate rule proposal that would "further expand the scope of products that are eligible for treatment as part of the Commission approved Portfolio Margin Pilot Program . . . [and] eliminate the requirement for a separate cross-margin account for margining eligible security products with eligible commodity products."[26] This proposal would expand the eligible products to include: (i) all margin eligible securities, listed options, OTC derivatives, U.S. security futures, and options on security futures under certain conditions; (ii) a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a "ready market" under SEC Rule 15c3-1 or a "no-action" position issued thereunder; and (iii) related instruments as defined in section 2(D).[27]

The NYSE also proposed modest amendments to the provisions concerning minimum account equity[28] and margin deficiencies.[29] The NYSE proposal makes only

---

23 SR-NYSE-2005-93, Rel. 34-53126 (Jan. 13, 2006) ("NYSE 2005 Proposing Release"). The letters from Chairman Cox to Messrs. Brodsky and Thain do not appear to be available on the SEC's website.

24 NYSE 2005 Proposing Release at 37-39.

25 We appreciate that there are some differences between the NYSE and CBOE proposals. Federated does not take a position on these differences, but requests only that MMFs be eligible collateral under both sets of portfolio margining rules.

26 SR-NYSE-2006-13; Rel. 34-53577 (Mar. 30, 2006) ("NYSE 2006 Proposing Release").

27 *Id*. at 11, 39.

28 *See* Proposed NYSE Rule 431(g)(9).

technical changes to the provision regarding determination of value for margin purposes to reflect the consolidation of portfolio and cross-margining accounts.[30] It also makes technical changes to the net capital provision.[31]

Similarly on February 2, 2006, the CBOE filed with the SEC an expanded version of its portfolio margining rules.[32] Briefly, the amendment would allow portfolio margining of listed equity options, including options on exchange-traded funds; narrow-based index options; security futures products; and unlisted derivatives. The inclusion of offsetting (underlying) equity securities and related instruments (i.e., futures, options on futures) as well as certain unlisted options, forward contracts and swaps (or unlisted derivatives) is also proposed.[33] The definition of "underlying instrument" has also been expanded.[34] As amended, revised Rule 9.15(d) would permit portfolio margining for all positions in index and equity options, security futures products, and index warrants listed on a national securities exchange, underlying instruments (including exchange traded funds and other fund products registered under the 1940 Act that are managed to track the same index that underlies permitted index options). Additionally, an account that elects to operate with account net equity of not less than $5 million may carry positions in unlisted derivatives (*e.g.*, OTC swaps, options) that have the same underlying instrument as an index or equity option and can be priced by an approved vendor of theoretical values.

---

29 *See* Proposed NYSE Rule 431(g)(10).

30 *See* Proposed NYSE Rule 431(g)(11).

31 Proposed NYSE Rule 431(g)(12). In the NYSE 2005 Proposing Release, the NYSE proposes to require member firms to deduct from net capital the amount of a margin call not met by the close of business on T+1. The CBOE proposed essentially the same requirement in its CBOE 2006 Proposing Release, discussed *infra.*

32 SR-CBOE-2006-14; Rel. 34-53576 (Mar. 30, 2006) ("CBOE 2006 Proposing Release").

33 *Id.* at 1, 35, 35 n.3.

34 *Id.* at 4.

The CBOE explains that it has proposed these changes in a manner consistent with the recommendations of a portfolio margining working group of the SIA.[35] In describing the filing, the Commission notes that CBOE Rule 12.4:

> currently requires a person or entity that wishes to open a portfolio margin account to have and maintain $5 million dollars in account equity. *** CBOE proposes to eliminate the requirement of a $5 million account equity requirement except for accounts that carry unlisted derivatives.[36]

The CBOE made a number of other changes. These include the following:

> For added safety and soundness, the [CBOE] is also proposing a change to Rule 12.4 that would require carrying firms to deduct the amount of any outstanding customer margin call in a portfolio margining customer's account from net capital on T+1. Additionally, an amendment is proposed that would prohibit entry of new orders that would increase the margin requirement once a margin call is made, and continuing until the margin call is met.[37]

We appreciate that there are a number of legal and operational hurdles that remain before investors and firms extensively use portfolio margining and cross-margining.[38]

---

[35] *Id.* at 34.

[36] *Id.* at 36.

[37] *Id.* at 38.

[38] *See, e.g.,* the SIA *Ad Hoc* Portfolio Margining Committee letter stating that the provisions outlined in the NYSE 2005 Proposing Release do not address all concerns with portfolio margining:

> Futures contracts are governed by the Commodity Exchange Act ("CEA") and regulated by the CFTC [Commodity Futures Trade Commission]. The Committee is not aware that the CFTC has granted to a broker-dealer that is also registered as a Futures Commission Merchant ("FCM") any exemption from requirements of the CEA or CFTC rules relating to, for example, the requirement to segregate customer funds securing futures positions. Thus, without further regulatory action, a broker-dealer/FCM using the cross-margin account would appear to be in violation of the CEA and CFTC rules.

Nonetheless, we believe that the efforts of all concerned parties can make portfolio margining even more practical and useful.

Request re Margin Collateral

Federated believes that a broker-dealer, FCM[39], or their customers, should be permitted to use shares in a MMF as collateral for margin including for the purpose of meeting any portfolio margin maintenance deficiency. As noted, the Board's margin rules and SRO margin rules for securities and security futures permit the use of MMFs for margin. We also note that MMFs have an extraordinary record of safety and dependability. The Commission's regulation of MMFs under Rule 2a-7 of the 1940 Act has been a great success. As a consequence, millions of individual American investors and institutions appropriately trust MMFs as safe and reliable. The Investment Company Institute reported that there were $2.039 trillion total money market mutual fund assets for the week ended May 3, 2006.[40] We do not believe that there is any justification for concluding that although MMFs would be appropriate for margin in other settings, somehow they are not appropriate for portfolio margin.

In our view, the Exchanges should permit any MMF, as defined under Rule 2a-7 of the 1940 Act, to be an acceptable form of margin under their respective portfolio margining rules. In addition, MMFs should be given the same treatment for margin purposes as cash or other marginable securities and without any additional reductions in value or haircut. We also request that MMFs should qualify for the $5 million dollar minimum asset test that the portfolio margin rules currently contemplate. In our view, any MMF assets that a customer holds at the relevant broker-dealer or FCM should be counted towards the $5 million minimum.[41] Typically, broker-dealers pledge shares in

---

Letter from Gerard J. Quinn, Vice President and Associate General Counsel, SIA, to Nancy M. Morris, Secretary, SEC, Feb. 13, 2006.

39 Our request with regard to FCMs only concerns such accounts that would be related to portfolio or cross-margining.

40 http://www.ici.org/stats/mf/mm_05_04_06.html#TopOfPage

41 *See* discussion *infra.*

MMFs through the facilities of the Depository Trust Company ("DTC"). Broker-dealers, FCMs, and their customers should be able to use MMFs to satisfy margin deficiencies either by pledging their shares through DTC or by other reasonable commercial means. We respectfully request that the Exchanges either issue interpretations confirming that MMFs may be used as described above, or explicitly amend their rules to so state. Finally, we request that the Exchanges confirm our understanding that they would value MMFs at their Net Asset Value ("NAV") for margin purposes and not discount them.[42]

---

[42] Current NYSE Rule 431(f)(10) provides:

> Determination of Value for Margin Purposes.—For the purposes of this paragraph (g), all listed index options and related instrument positions shall be valued at current market prices. Account equity for the purposes of this paragraph (g) shall be calculated separately for each portfolio margin account by adding the current market value of all long positions, subtracting the current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.

The NYSE 2005 Proposing Release would amend this section slightly:

> (11) [(10)] Determination of Value for Margin Purposes.-- For the purposes of this section [paragraph] (g), all eligible products [listed index options] and related instrument positions shall be valued at current market prices. Account equity for the purposes of this section [paragraph] (g) shall be calculated separately for each portfolio margin or cross-margin account. [by adding the current market value of all long positions, subtracting the current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.]

In the text in both the footnote above and the footnote below, additions are indicated by italics and deletions are in brackets.

The NYSE 2006 Proposing Release would provide:

> (11) Determination of Value for Margin Purposes.—For the purposes of this section (g), all eligible products and related instrument positions shall be valued at current market prices. Account equity for the purposes of [this] section*s (g)(9)(A) and (g)(10)(A)* shall be calculated separately for each portfolio margin [or cross-margin] account.

Similarly, CBOE made comparable changes to its rules:

We also appreciate that some may be concerned that the use of MMFs in this context may raise questions under Section 11(d)(1) of the Exchange Act. We respectfully urge the Commission and the Exchanges to address this ambiguity and state either that the use of MMFs for portfolio margining purposes is outside the scope of Section 11(d) of the Exchange Act or to grant an exemption from Section 11(d)(1) of the Exchange Act (or issue no-action relief) for MMFs when used in conjunction with portfolio margin.[43] We believe such a request is consistent with the requirements of the Exchange Act for the following reasons:

- Customers, broker-dealers, and FCMs would be using the MMFs for the purposes of adding collateral to an account. Customers, broker-dealers, and FCMs would not be seeking to buy the MMFs on credit. Any theoretical extension of credit on the MMFs only would occur as a consequence of depositing the MMF share in the margin account (or otherwise using it for collateral purposes). There would be no intention to have the broker-dealer or FCM explicitly extend credit to the customer for the purpose of purchasing new shares of MMFs.[44]

> (h) *Determination of Value for Margin Purposes.* For the purposes of this Rule 12.4, all listed index options and related instrument positions shall be valued at current market prices. Account equity for the purposes of this Rule 12.4 shall be calculated separately for each portfolio margin account by adding the current market value of all long positions, subtracting the current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.

The CBOE 2006 Proposing Release indicates that the CBOE only would make conforming changes to this provision, replacing "listed index options and related instruments" with "eligible."

43 As appropriate, Federated would be happy to submit a separate request for an exemptive order from the Commission or request no-action relief from the Staff.

44 Loss and Seligman, *supra* note 14, at text accompanying notes 261 and 262:

> The Report of the Senate Banking and Currency Committee's investigation, on the other hand, says that the margin provisions are also intended "to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin." As Chairman Rayburn of the House Commerce Committee put it in language no less forceful for its mixed metaphor: "A reasonably high margin requirement is essential so that a person cannot get in the market on a shoe string one day and be one of the sheared lambs when he wakes up the next morning."

- We appreciate that in conjunction with no-action requests under Section 11(d)(1), the Staff has expressed concern about negative spread. We note that the investors involved with portfolio margin (and the products involved in such a portfolio) are likely to be highly sophisticated and in certain instances would be subject to a $5 million minimum.[45] Accordingly, there is little risk that the investors who use MMFs unknowingly would be paying a "negative spread" to the broker-dealer. Moreover, customers, broker-dealers, and FCMs are more likely to use MMFs as maintenance margin and therefore their use would be more in the nature of performance bond, rather than a financing mechanism.[46]

For these reasons, we also believe that MMFs used for portfolio margin should not be subject to the thirty-day waiting period provided in Rule 11d1-2.

(Footnotes omitted).

In our view, the risks that Chairman Rayburn articulated are not present because, among other reasons, we are not proposing the extension of credit with regard to the purchase of MMFs themselves. Moreover, we do not believe that the risks of portfolio margining would be increased by permitting the use of MMFs as margin collateral.

45 We note that both the Exchanges propose to reduce the scope of the $5 million minimum account requirement. (Federated takes no position on this aspect of the proposals.) We believe that even if the Commission approves the proposals including these reductions, portfolio margining remains a product that only the most sophisticated investors will use.

46 We are not suggesting that a sophisticated investor, broker-dealer, or FCM should never knowingly be able to use a MMF for initial margin.

* * * *

Again, we commend all interested parties for their efforts to expand portfolio margining. We appreciate the Commission's consideration of this comment letter. Please contact me at 202.261.3314 if you have any questions.

Sincerely,

[S]

Stuart J. Kaswell
Partner

C: The Honorable Christopher Cox
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
Scott Holz, Board of Governors of the Federal Reserve System
Richard A. Shilts, Acting Director, Division of Market Oversight, Commodity Futures Trading Commission
James Adams, Chicago Board Options Exchange
Albert Lucks, New York Stock Exchange Group, Inc.
Larry Thompson, Depository Trust & Clearing Corporation
Susan DeMando, NASD
Andrew Naughton, The Options Clearing Corporation
Gerard J. Quinn, Securities Industry Association
Barbara Wierzynski, Futures Industry Association
Eugene F. Maloney, Esq., Executive Vice President and Corporate Counsel, Federated Investors, Inc.