Securities Industry Association
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February 13, 2006

Nancy M. Morris,
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-9303

Re: File Number SR-NYSE-2005-93, 71 Fed.Reg. 3586 (January 23, 2006)

Dear Ms. Morris:

On behalf of the *Ad Hoc* Portfolio Margining Committee ("the Committee") of the Securities Industry Association ("SIA")[1] we are pleased to offer you our comments on the above referenced proposal by the New York Stock Exchange ("NYSE") that would amend the Portfolio Margin Pilot Program ("the Pilot Program") in NYSE's Rule 431(g). If adopted as proposed, the amendments will expand the scope of financial instruments eligible for "portfolio margining" to include securities futures and single stock options.[2]

<u>Overview</u>

The Committee is strongly supportive of the NYSE's efforts to incorporate portfolio margining into Rule 431 and hopes that the Commission will speedily approve amendments to Rule 431 to increase the scope of portfolio margining. SIA has long and consistently supported regulatory steps that would encourage the adoption of portfolio margining to include the broadest line of products whose market risks can be modeled and that can offset market risks within a portfolio.[3] Accordingly, we view the current proposal as an important but *incremental* step in that direction. In the strongest possible terms, the Committee urges the NYSE, the Commission, and other financial market

[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)
[2] *See* Release No. 34-52031 (July 14, 2005), 70 FR 42130 (July 21, 2005); (File No. SR-NYSE-2002-19).
[3] For example, *see*, Testimony of Marc E. Lackritz, President, Securities Industry Association, "Examining the Commodity Futures Modernization Act of 2000 and Recent Market Developments" Before the Committee on Banking, Housing and Urban Affairs, United States Senate - September 8, 2005.

regulators to work cooperatively in expanding the category of financial instruments eligible for portfolio margining. The regulatory community has recognized the importance of portfolio margining in the conduct of our businesses. Eight years ago the Federal Reserve Board amended Regulation T to provide an exemption for any portfolio margining system permitted by a self-regulatory organization pursuant to SEC-approved rules.[4] After enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"), the Federal Reserve Board in a letter addressed to the Acting Chairmen of both the Commission and of the Commodity Futures Trading Commission ("CFTC") reiterated its encouragement for the development of "more risk-sensitive portfolio margining approaches *for all securities*, including security options and security futures products."[5] As we have indicated in previous letters on this topic, representatives of the Committee and of other SIA organizations would be pleased to assist the Commission and other regulators in working toward such a goal.

While generally supportive of the NYSE's proposed rule amendment, the Committee finds three aspects of the proposal problematic.

Comments on the Filing

1. Eligible Products. The expansion of the Pilot Program from broad-based indexes to individual equities covers only the derivatives on individual equity securities -- securities futures and individual stock options -- and does not include long and short positions in the stocks themselves. The Committee is strongly of the view that long or short positions in individual stocks should be included in eligible products. We note that the proposal includes exchange traded funds among eligible products and that the inclusion of cash market stock positions would not require an amendment of the method for computing margin requirements.

Moreover, because the liquidity of the cash markets and the securities futures markets differ, customers should not be given an incentive to trade in what may be the less liquid market. For example, a customer short a call option and long a security future on the same underlyer may be able to reverse or trade out of his long exposure at a better price in the cash market than in the securities futures market. Assuming the customer continues to hold the option position, the lack of flexibility to include cash positions in the portfolio margin account adds risk and inefficiencies to maintaining the portfolio. The Committee believes that the exclusion of cash positions from the proposal will significantly diminish its usefulness to our clients.

2. Cross Margining Under the proposal, futures positions are "related instruments" and thereby eligible to be included in the computation of margin on a portfolio basis. However, the inclusion of futures positions (other than securities futures) within a portfolio brings the requirement of a cross-margining account, in addition to and separate

[4] 63 Fed. Reg. 2805 (Jan, 16, 1998).
[5] Board of Governors of the Federal Reserve System, to James E. Newsome, Acting Chairman, Commodity Futures Trading Commission, and Laura S. Unger, Acting Chairman, Securities and Exchange Commission, March 6, 2001 (*emphasis added*).

from the portfolio margin account, to hold the futures and related securities positions. Margin (and equity) must be computed separately for positions in the portfolio and cross-margin accounts. Both accounts are "securities accounts".

There are two problems with this structure. The first is legal. Futures contracts are governed by the Commodity Exchange Act ("CEA") and regulated by the CFTC. 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. We urge the Commission to work with the CFTC, the exchanges, and the clearing organizations to address and resolve the legal and regulatory issues that may create a barrier to comprehensive cross-margining at the firm and clearing level.[6]

The second problem with the proposed structure is operational. Maintaining and monitoring two separate margin accounts for a client's trading activities will be cumbersome for both the broker-dealer and the client.

The Committee believes that the ideal structure is to have a single account at the firm level in which all eligible products (including futures) can be carried. This would allow for a single computation of a margin requirement and equity. Again, ideally, there would be one combined position at the clearing level for customer futures and options positions. The two-account model contained in the Pilot Program and carried forward in the proposal appears to the Committee to be unnecessary. In the event that we have misunderstood this aspect of the proposal, we request that the operation of the cross-margin account be more clearly explained.

3. **Margin Calculation.** Section (g)(7) of the Pilot Program sets forth the methodology for computing initial and maintenance margin and contains an alternative test for computing the minimum margin required. Subsection (B) requires that in calculating the minimum margin, firms apply a factor of $.375 per contract times the instrument's multiplier.[7] The Committee notes that the minimum amount set forth in Appendix A of Rule 15c3-1 (on which the margin methodology is based) is $.25 per contract. The Committee would like the NYSE and the Commission to consider changing the minimum requirement in subsection (B) to be equivalent to the amount specified in Appendix A. The Committee also believes that a more robust method for computing the minimum – both in Appendix A and for the portfolio margin rule – is a model-based approach derived from "shocking" the implied volatility of the contract. The Committee expects to discuss this approach further with staff of the NYSE, the Options Clearing Corp. and the Commission. Cross-referencing Appendix A for

[6] These issues include the applicability of the Securities Investor Protection Act and the status of customer collateral securing positions in the cross-margin account when deposited in the futures clearing system.
[7] For example, a listed stock option covers 100 shares. Assuming that the contract's market value is not less, then one option contract's minimum would be $37.50.

purposes of Subsection (B) at this time will make further amendments of Rule 431 unnecessary as the equivalent provision in Appendix A is further refined.

The Committee appreciates the opportunity to submit our comments on the NYSE proposal. We wish to reiterate our strong support for the proposal and our wish that the Commission and other regulators will continue their efforts to expand the category of products eligible for portfolio margining. If you have any questions concerning our letter or wish to discuss the subject matter, please do not hesitate to contact the undersigned.

Sincerely,

/s/ Gerard J. Quinn
Gerard J. Quinn
Vice President and
Associate General Counsel