August 26, 2019

VIA ELECTRONIC SUBMISSION

Vanessa Countryman
Acting Secretary
U.S. Securities and Exchange Commission
100 F St., NE
Washington, DC 20549-1090
File No S7-09-19; RIN: 3235-AM55

Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre,
1155 21st St., NW
Washington, DC 20581
RIN: 3038-AE88

Re: Customer Margin Rules Relating to Security Futures

Dear Madam/Sir:

The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (together, the "Commissions") are requesting comment on a proposal to lower minimum customer margin requirements for unhedged security futures from 20% to 15%.\(^1\) As leaders in exchange-traded derivatives, Cboe Global Markets, Inc. ("Cboe") and MIAX Exchange Group ("MIAX") (hereinafter the "Options Exchanges") appreciate the opportunity to provide feedback on the proposal.

As recognized by the Commissions, lower margin requirements for one product can create regulatory advantages over another product.\(^2\) Thus, margin requirements for security futures and exchange-

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\(^2\) 2019 Proposal at 36448.
traded options (which create similar risk profiles to security futures) were a particular area of focus of the Commodity Futures Modernization Act of 2000 ("CFMA"). Ultimately, to prevent regulatory arbitrage between security futures and exchange-traded options and to ensure that exchange-traded options were not unfairly disadvantaged by security futures margin requirements, the CFMA specifically mandated that security futures margin levels could be no lower than margin levels applicable to comparable options positions.

Consistent with the CFMA, current minimum margin levels for unhedged security futures and exchange-traded options are in sync — inside and outside of a portfolio margin account. In portfolio margin accounts both unhedged security futures and exchange-traded options are subject to minimum margin of 15%. Similarly, outside of a portfolio margin account both unhedged security futures and exchange-traded options are subject to margin of 20%. The Commissions are now proposing to lower margin levels for security futures held outside of a portfolio margin account to 15% while margin levels for exchange-traded options held outside of a portfolio margin account are to remain at 20%.

The Options Exchanges are concerned that this proposal would disrupt the regulatory parity that currently exists between security futures and exchange-traded options as the proposal would create preferential margin levels for unhedged security futures held outside of a portfolio margin account. This would potentially create a competitive disadvantage for exchange-traded options strategies and is inconsistent with the CFMA. In order to remain consistent with the CFMA and ensure a level playing field between competing products, the Options Exchanges believe margin levels for unhedged security futures held outside of a portfolio margin account should be no lower than margin levels for exchange-traded options held outside of a portfolio margin account.

**Background**

In December 2000, the CFMA became law, lifting the ban on single stock and narrow-based stock index futures ("security futures"). The CFMA called on the Board of Governors of the Federal Reserve System (the “Board”) to issue rules governing customer margin for transactions in security futures; specifically, to prescribe rules establishing initial and maintenance customer margin requirements imposed by brokers, dealers, and members of national securities exchanges for security futures products. Prior to the adoption of the CFMA there was great concern that the newly created security futures product would have an unfair regulatory advantage over existing exchange-traded options, which create similar risk profiles as security futures products and would directly compete with them. In order to prevent regulatory arbitrage or a competitive disadvantage for exchange-traded options, the CFMA amended Section 7(c) of the Securities Exchange Act of 1934 to provide that the rules setting forth customer margin requirements for security futures products must, among other things, “be consistent with the margin requirements for comparable option contracts traded on any [national securities exchange].”

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4 See Section 7(c)(2)(B) of the Securities Exchange Act of 1934.
5 See Customer Margin Rules Relating to Security Futures, Securities Exchange Act Release 44853 (September 26, 2001), 66 FR 50720 (October 4, 2001), FN 10 (joint rulemaking by the Commissions, hereinafter the “2001 Proposal”) (recognizing “that security futures can compete with, and be an economic substitute for, equity securities, such as equity options.”).
More importantly, Section 7(c) also provided that initial and maintenance margin levels for a security future could not be “lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any [national securities exchange], other than an option on a security future.”

In March 2001, the Board delegated its authority to set security futures margin requirements jointly to the Commissions. In August 2002, the Commissions finalized customer margin rules for security futures, setting minimum required margin for security futures at 20%. In finalizing the customer margin rules the Commissions made three critical findings:

1) a security future is comparable to a short, at-the-money option;
2) a short, at-the-money option is subject to margin of 20%; and
3) a minimum margin level for security futures of 20% satisfies the requirement that security futures margin can be no lower than the lowest level of margin for a comparable option contract as required by the CFMA.

Additionally, as a part of the 2002 rulemaking the Commissions considered whether security futures should be portfolio margined. At the time, the Commissions had approved portfolio margining systems in a number of cases; however, with respect to customer accounts, the Commissions had not yet approved portfolio margining systems for exchange-traded options. Because portfolio margining had not yet been approved for exchange-traded options the Commissions “determined that risk-based portfolio margining for security futures will not be permitted until a similar methodology is introduced for comparable exchange-traded options.”

The 2002 Final Rules instituted further parity by also requiring a portfolio margining system for security futures to meet the criteria of Section 7(c)(2)(B), which, again, among other things, mandates margin requirements for security futures be consistent with the margin requirements for comparable exchange-traded options and that margin levels for security futures not be lower than the levels of margin required for comparable exchange-traded options. The Commissions specifically noted that requiring portfolio margining to comply with section 7(c)(2)(B) was “intended to clarify that the

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7 Id.
8 Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC (March 6, 2001) (“FRB Letter”).
10 2002 Final Rules at 53157.
11 Id.
12 For example, the CFTC had approved portfolio margining for existing futures contracts; the SEC had approved portfolio margining for margin collected by the Options Clearing Corporation for the options positions of its clearing members; and the Commissions had approved self-regulatory organization rules that permit the use of portfolio margin for certain cross-margining arrangements involving futures and securities. Id. at 53149.
13 Id.
14 See CFTC Rule 41.45(b)(2) and SEC Rule 403(b)(2).
[security futures] portfolio margining system must be consistent with a risk-based system used for comparable exchange-traded options.”\(^{15}\)

Following the 2002 Final Rules, SROs adopted portfolio margining programs that allow both security futures and exchange-traded options to be portfolio margined if held in a securities account.\(^{16}\)

**Discussion**

The instant proposal seeks to lower minimum customer margin requirements for unhedged security futures held outside of a portfolio margin account from 20% to 15% while margin for exchange-traded options held outside of a portfolio margin account is to remain at 20%. In order to effect this change, the proposal does not seek to modify the original finding that a security future is comparable to a short, at-the-money option. Rather, the Commissions take the position that after the advent of portfolio margining “certain types of exchange-traded options, no matter what type of an account they are in, are comparable to security futures.”\(^{17}\) The effect is to compare security futures margin levels held outside of a portfolio margin account to margin levels for exchange-traded options held in a portfolio margin account. The Options Exchanges believe this is inconsistent with the CFMA and will create an unnecessary and inappropriate regulatory advantage for security futures.

The margin treatment of exchange-traded equity options held inside a portfolio margin account should not be compared to the margin treatment for security futures held outside of a portfolio margin account.

In the Board’s letter delegating authority to the Commissions to set margin levels for security futures the Board encouraged the development of more risk-sensitive, portfolio-based approaches to margining security futures products and exchange-traded options.\(^{18}\) The Board did not, however, indicate that if such portfolio margin systems were developed it would be appropriate to compare margin levels inside a portfolio margin account to margin levels outside of a portfolio margin account. Yet, the instant proposal makes that comparison, stating that “exchange-traded options, no matter what type of an account they are in, are comparable to security futures.”\(^{19}\) The Options Exchanges disagree and do not believe the Board’s promotion of portfolio margin was intended to imply that if and when portfolio margin exists it should impact margin levels outside of portfolio margin accounts.

First, portfolio margin accounts are special accounts not meant for all individuals. As the Commissions noted “[p]ortfolio margining establishes margin levels by assessing the market risk of a ‘portfolio’ of positions in securities or commodities. Under a portfolio margining system, the amount of required margin is determined by analyzing the risk of each component position in a customer account (e.g., a class of option with the same expiration date) and by recognizing any risk offsets in an overall portfolio of positions (e.g., across options and futures on the same underlying instrument).”\(^{20}\) Importantly, in

\(^{15}\) 2002 Final Rules at 53148.

\(^{16}\) See Cboe Exchange, Inc. Rule 12.4 and FINRA Rule 4210(g).

\(^{17}\) 2019 Proposal at 36440.

\(^{18}\) Board letter, appendix B to the 2001 Proposal.

\(^{19}\) 2019 Proposal at 36440.

\(^{20}\) 2002 Final Rules at 53148.
order to offer portfolio margin accounts Cboe and FINRA Rules require a creditor (clearing broker-dealer) to meet strict eligibility criteria and obtain prior approval from its Designated Examining Authority (“DEA”). Additionally, as part of the approval process, clearing firms are required to implement up/down market move assumptions greater than the SRO minimum when warranted. Thus, they are required to assess the risk of each underlying equity security and set up/down market move assumptions commensurate for each. Accordingly, the 15% minimum up/down market move is permitted only for those equities for which it would be appropriate. In the case of many equity securities, even a 20% margin level is less than the actual up/down market move implemented in broker-dealer portfolio margin systems.

Furthermore, not all investors can open a portfolio margin account. Under Cboe and FINRA Rules, a portfolio margin account can be opened only if it is approved for writing uncovered options (even if the account holder has no interest in writing uncovered options). Additionally, as part of the approval process mentioned above, a creditor is required to implement a minimum equity requirement for portfolio margin accounts. The minimum equity required by the DEA well exceeds that typically needed in order to meet creditors' uncovered option writing approval standards. In most cases, and as intended, portfolio margin accounts are used by investors that are knowledgeable, experienced and have financial means.

In short, given the nature of portfolio margin accounts, including other controls that are in place, the 15% **minimum** up/down market move assumption in a portfolio margin account is prudent. The premise that margin levels for portfolio margin accounts should inform margin levels outside of portfolio margin accounts belies the special nature of portfolio margin accounts and the fact that a limited population of investors have access to those accounts.

Second, as set forth in the 2002 Final Rules, minimum margin levels for security futures held outside of a portfolio account do not govern the levels of margin applicable for security futures held in a portfolio margin account. Similarly, the rules governing levels of margin for exchange-traded options held outside of a portfolio margin account (i.e., Regulation T or strategy-based margin rules) do not govern the levels of margin for an equity option held in a portfolio margin account. The Options Exchanges believe it is misguided to compare margin levels outside of a portfolio margin account (for security futures) to margin levels inside of a portfolio margin account (for exchange-traded options).

Third, the Options Exchanges are longstanding supporters of portfolio margin and are fully supportive of pursuing industry solutions and rule changes that would optimize portfolio margin requirements for security futures and exchange-traded options. To the extent securities accounts are not operationally optimal for security futures, the Options Exchanges support industry efforts to make improvements. To the extent rules are needed to allow portfolio margining of security futures in future accounts, the Options Exchanges support implementation of those rules and support the Commissions’ statements

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21 See e.g., Cboe Exchange, Inc. Rule 12.4.
22 2002 Final Rules at 53150.
23 The Board’s Regulation T governs the extension of credit by brokers and dealers. Regulation T, however, specifically does not apply to “[f]inancial relations between a customer and a creditor to the extent that they comply with a portfolio margining system under rules approved or amended by the SEC.” 12 CFR 220.1(b)(3)(i).
encouraging “market participants to develop a portfolio margining proposal for security futures.”[24]

However, the Options Exchanges cannot support a workaround that is inconsistent with the CFMA and would disadvantage options held outside of portfolio margin accounts.

The proposal, if adopted, would create a regulatory arbitrage advantage for security futures over competing exchange-traded options.

As noted by Cboe and other options exchanges at the time, the CFMA was specifically designed to avoid regulatory arbitrage between security futures and exchange-traded options.[25] The House Commerce Committee Report on the CFMA recognized that harmonizing core regulatory areas for security futures and exchange-traded options was intended “to minimize competitive disparities between the markets.”[26] For their part, the Commissions recognized in 2001 that “security futures can compete with, and be an economic substitute for, equity securities, such as equity options”[27] and sought to carry out the legislative intent of the CFMA by allowing “security futures products to trade in a fair and competitive manner... while avoiding regulatory arbitrage between the options and futures markets.”[28]

At the SEC’s Open Meeting approving the 2002 Final Rules Chairman Pitt and the other SEC Commissioners again reaffirmed the importance of preventing regulatory arbitrage by obtaining assurances from SEC staff that the security futures margin rules did not create regulatory arbitrage with exchange-traded options.

Yet, the instant proposal implies that exchange-traded options and security futures are not competing products, stating that “from the perspective of market participants, exchange-traded options and security futures often serve two distinct economic functions.”[29] The proposal suggests that exchange-traded options are for hedging and speculating on underlying equity markets, and security futures are for establishing “synthetic long or short exposure to the underlying equity security or equity securities” and/or “temporarily transfer[ing] securities, similar to securities lending or equity repurchase agreements.”[30] This analysis unfairly underestimates the utility of options.

Exchange-traded options are indeed tools for hedging and speculating, but they are also regularly used to establish synthetic long and short exposures that are nearly identical to exposures created by security futures. As the Commissions noted in 2001, “a synthetic futures contract may be created by two option contracts based on the same underlying instrument. To create a synthetic long (short) futures contract, an investor would buy (sell) a call option and sell (buy) a put option on the same

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24 2002 Final Rules at 53149.
27 Supra note 6.
29 2019 Proposal at 36435.
30 Id.
underlying security, with the same expiration date and strike price.”\textsuperscript{31} In fact, synthetic futures strategies are an important segment of today’s options market, competing everyday with security futures. For example, in June 2019, there were over 700,000 contracts traded on Cboe exchanges in strategies that replicate long and short security futures.

In addition, the Commissions note that “security futures traded in Europe are subject to risk-based margin calculations that differ from the margin requirements that apply to security futures in the U.S.”\textsuperscript{32} While interesting, margin methodologies in Europe are irrelevant to whether the proposal is consistent with the CFMA or whether the proposal would unfairly disadvantage the U.S. options industry. Moreover, it is worth noting that in June 2019, Eurex, the only exchange in Europe offering security futures on U.S. listed securities, traded less than 5,000 contracts on U.S. listed securities and had open interest of less than 6,000 contracts.\textsuperscript{33} Regardless, alleviating regulatory arbitrage that potentially benefits European exchanges does not justify creating regulatory arbitrage in the U.S. that would harm the U.S. options markets.

Irrespective of whether security futures and exchange-traded options currently serve distinct economic functions or whether European exchanges have different margin methodologies, adopting preferential margin treatment for security futures in the U.S. would create a regulatory arbitrage in the U.S. that the CFMA sought to prevent. This would harm the U.S. options markets.

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Congress absolutely prohibited security futures margin from being lower than margin for a comparable exchange-traded option. The Options Exchanges believe an unhedged security future held outside of a portfolio margin account is comparable to an exchange-traded option held outside of a portfolio margin account. These options are subject to margin of 20%; thus, fairness, regulatory parity, and, more importantly, the CFMA require margin levels for security futures held outside of a portfolio margin account to remain at 20%.

Sincerely,

Angelo Evangelou
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Cboe Global Markets, Inc.

Shelly Brown
EVP, Strategic Planning & Operations
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\textsuperscript{31} Supra note 6.
\textsuperscript{32} 2019 Proposal at 36436.
CC: Commodity Futures Trading Commission
The Honorable Heath P Tarbert, Chairman
The Honorable Rostin Benham, Commissioner
The Honorable Dawn DeBerry Stump, Commissioner
The Honorable Dan M. Berkovitz, Commissioner
The Honorable Brian D. Quintenz, Commissioner
Brian Bussey, Director, Division of Clearing and Risk
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The Honorable Elad L. Roisman, Commissioner
The Honorable Robert J. Jackson Jr., Commissioner
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