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May 19, 2006

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

Re: Portfolio Margin and Cross-Margin Proposals: SR-NYSE-2006-3 and SR-CBOE-2006-14

Dear Ms. Morris:

The Options Clearing Corporation ("OCC") is pleased to offer our comments in connection with the above referenced proposals by the New York Stock Exchange ("NYSE") and the Chicago Board Options Exchange ("CBOE") (collectively, the "Exchanges"), which would very substantially expand the existing Portfolio Margin Pilot Program (the "Pilot Program") set forth in NYSE Rule 431(g) and CBOE Rule 12.4. The proposals of both Exchanges would permit the inclusion in a portfolio margin account of broad-based index futures and options thereon ("futures products").[1] This "cross-margin" aspect of the Pilot Program involves the assessment of a single margin requirement with respect to a "portfolio" of investments that include both securities subject to the Commission's jurisdiction and futures products subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC").

The Exchanges' current rule filings are potentially revolutionary in their impact. The Pilot Program would allow a single portfolio margin account in which all equity and equity-index related financial products (including stocks, exchange-traded stock options, index options, security futures, broad-based index futures and options thereon and over-

[1] Both proposals refer to these futures products as "related instruments." The NYSE proposal would eliminate the existing requirement that cross-margining accounts be identified separately from portfolio margining accounts not containing futures products, and we understand that the CBOE is considering conforming its proposal to that of the NYSE in this regard. Accordingly, we refer in this letter to a "portfolio margining account"

the-counter ("OTC") derivatives on underlying equities and indexes can be combined and financed based on the net risk of the positions. A portfolio margin account would not be subject to the position- and strategy-based credit limits that currently apply to securities accounts governed by Regulation T.[2] As amended by the current proposals, the Pilot Program will go a very long way toward allowing U.S. broker-dealers to provide the same services to eligible participants in the United States that can be provided by financial intermediaries to their customers in most other financial centers of the world. It is anticipated that the Pilot Program will encourage the repatriation of a very large volume in financial transactions involving U.S. securities that is currently done in London and elsewhere by non-U.S. firms and by U.S. firms through their foreign affiliates.

Notwithstanding that the Pilot Program provides for the inclusion of futures products in portfolio margin accounts, OCC is concerned that implementation of cross-margining in these accounts will be indefinitely delayed—and unnecessarily so—unless the Commission and the CFTC are each willing to take action to remove technical legal barriers to implementation that result from differences between their respective regulatory regimes. Unless the Commission and the CFTC take action to remove these barriers, they will effectively exclude U.S. futures products from portfolio margin accounts and thereby potentially diminish their value as a hedging tool in connection with investments in U.S. equities and equity-related derivatives. Our comments in this letter are offered in the hope of facilitating a speedy resolution of these issues.

OCC's Role and the History of Cross-Margining

The Options Clearing Corporation ("OCC") is a securities clearing agency registered with and regulated by the Commission under Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act"). In that capacity, OCC clears all options traded on U.S. national securities exchanges[3] as well as security futures traded on OneChicago, LLC. OCC is also a derivatives clearing organization ("DCO") registered with and regulated by the Commodity Futures Trading Commission (the "CFTC") under Section 5b of the Commodity Exchange Act (the "CEA"). In its capacity as a DCO, OCC clears transactions in futures contracts traded on the CBOE Futures Exchange. OCC is owned by five national securities exchanges, and its Board is composed principally of representatives of those exchanges and of OCC's clearing members. OCC operates effectively as a not-for-profit industry utility in that its principal source of

[2] Regulation T, promulgated by the Board of Governors of the Federal Reserve System pursuant to Section 7 of the Exchange Act, limits the amount of credit that a broker-dealer may extend to a customer to finance the purchase of securities. Section 220.1 of Regulation T provides that Regulation T "does not apply to . . . financial relations between a customer and a [broker-dealer] to the extent that they comply with a portfolio margining system under rules approved or amended by the SEC." The Pilot Program is such a margining system.

[3] American Stock Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE Arca, Philadelphia Stock Exchange, and the Boston Stock Exchange.

income is the fees paid by its clearing members, to whom OCC annually refunds the excess of its income over its expenses and any amount needed as additional working capital.

Cross-margining is most efficient when it involves offsets between securities and futures products at both the firm level and at the clearing level. Because most U.S. futures products are cleared through the Clearinghouse Division of the Chicago Mercantile Exchange ("CME")[4] or other DCOs that are associated with a particular contract market, cross-margining between securities options and futures products at the clearing level is accomplished through cross-margining agreements between OCC and the DCO for the futures exchanges on which the particular futures products are traded. OCC and CME are currently participants in a cross-margining program that has operated successfully for many years and has brought tremendous benefits to our common members in the form of reduced margin requirements and operational efficiency. We believe that this program, which is currently available only to options market-makers and other "market professionals," can easily be expanded to provide similar accounts in which firms can carry positions and effect transactions for eligible participants in the Pilot Program. Indeed, OCC has been working along with the CBOE, the NYSE, the NYSE's Rule 431 Committee, committees of the Securities Industry Association, Futures Industry Association, CME and other industry groups to bring this about.

The Problem

While there is considerable complexity in the governing laws and regulations, the basic problem for cross-margining that is posed by the two different regulatory regimes is easily understood at a conceptual level. Under the rules governing the protection of customer funds and the liquidation of a broker-dealer ("BD") or futures commission merchant ("FCM") in the event of its insolvency, securities accounts and futures accounts exist in parallel universes. Futures accounts are subject to the segregation requirements of the CEA and would be liquidated under applicable provisions of the Bankruptcy Code and Part 190 of the CFTC's regulations. Securities accounts are subject to the Commission's Rule 15c3-3 and other customer protection rules and would ordinarily be liquidated in a proceeding under the Securities Investor Protection Act of 1970 ("SIPA"). Section 4d(a)(2) of the CEA requires that all funds and property (including securities held as collateral) in a customer's futures account must be segregated from all other funds and property, although it may be commingled with the property of other futures customers. If the FCM becomes insolvent, futures customers have claims against the pool of customer segregated funds.

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[4] The CME Clearinghouse Division clears futures products that are traded on the CME as well as on the Board of Trade of the City of Chicago ("CBOT").

On the securities side, the Commission's customer protection rules, roughly speaking, require segregation of the property of securities customers only to the extent that it exceeds the amounts owed by customers to the BD ("net segregation"). Nevertheless, in the event of the insolvency of the BD, a pool of customer funds of securities customers is created from which the claims of securities customers are to be paid. If a customer has both a securities account and a futures account, the customer has a separate claim against each separate pool of funds.

It is the essence of cross-margining that securities positions that liquidate to an asset may be used offset losses on futures positions that liquidate to a deficit and vice versa, and the same collateral is used to support both securities and futures positions. Until an insolvency actually occurs, it will ordinarily not be known whether the losses will be on the securities side or the futures side. Thus, cross-margining can work in one of only three ways: (1) all positions are carried in a futures account; (2) all positions are carried in a securities account, or (3) securities are carried in a securities account and futures in a futures account and collateral is apportioned between them on some basis, and in the event of a liquidation, the proceeds from the "winning" leg of a hedge are passed across the jurisdictional boundary from the pool of securities customer funds to the pool of futures customer funds or vice versa to make up the deficit in the customer funds pool having the shortfall. Either of the first two alternatives may be referred to as a "one-pot" approach. The third alternative can be referred to as a "two-pot" approach.

One-Pot vs. Two-Pots

The cross-margining programs between OCC and its cross-margining partners have all been one-pot models carried as futures accounts subject to CFTC segregation requirements. These programs have been limited to options market makers and other "market professionals" that are not deemed to be securities customers for purposes of the Commission's Rule 15c3-3, although they are "customers" for purposes of CFTC regulations and the futures insolvency rules. When expansion of the cross-margining program to include institutional customers was originally contemplated, OCC initially proposed that these accounts also should be treated as segregated futures accounts. At that time, however, the proposals were limited to cross-margining of securities index options and futures index products. It was not contemplated that these accounts, at the firm level, would contain single stocks or other underlying securities, and security futures were not then in existence.

Under the Pilot Program as it has evolved, the class of "eligible participants" includes a wide segment of persons who are, absent some form of exemption or exclusion, Rule 15c3-3 customers. In addition, and more importantly, the portfolio/cross-margin accounts now contemplated are accounts in which stocks and other traditional securities can not only be held but traded and financed. These are not functions that are typically conducted in a futures account. Moreover, a typical portfolio margin account will always be used for securities transactions, and it is anticipated that many portfolio margin accounts will have no futures positions. For these and other reasons, it has become apparent that customer portfolio margining accounts, under a one-pot approach, must be securities accounts. This has been discussed at some length in Rule 431 Committee meetings, with the staff of the SEC and the CFTC, and in many other forums within the securities and futures industries.

Within the past few months, however, there has been discussion among regulators and industry participants regarding the possibility of changing course to implement a "two-pot" approach at both the firm level and the clearing level. There is precedent at the clearing level for a two-pot approach. A "two-pot" model, was approved by the CFTC and the SEC in 2001 to permit hedging between positions in Government securities and repurchase agreements in Government securities and various interest rate futures or futures on Government securities. The two-pot approach was initially implemented between the Government Securities Clearing Corporation ("GSCC") (now called the Fixed Income Clearing Corporation or "FICC") and NYCC[5] and now includes a similar program between FICC and CME. It is important to note, however, that these programs are limited to proprietary positions of member firms and accordingly do not implicate the customer protection rules of either the SEC or the CFTC. At the firm level, no two-pot approach has ever been developed for customer accounts. The principal reason for this is that significant legal and regulatory issues would need to be resolved in order to implement a two-pot approach for customers.

We are aware that some CFTC staff members have indicated interest in a two-pot model for cross-margining, and that the CME has recently submitted a comment letter (the "CME Letter") to the Commission in the current proceeding in which they also indicate support for a two-pot approach as an initial step. While the CME Letter acknowledges that "[t]he one pot approach generally provides the most optimal level of economic risk offsets," it expresses the belief that a two-pot approach "more easily accommodates differences in customer protection mechanisms, capital requirement structures, and is operationally transparent to both clearing members and the end users . . ." as well as providing "greater certainty around the application of bankruptcy provisions." It is with reluctance and the greatest respect for the views of our cross-margining partner and the staff of the CFTC, which has on many occasions expressed a supportive, open-minded and constructive approach to cross-margining issues, that we put forward a different solution to the issues now being raised.

While a two-pot approach may be possible, we first of all note that there is no precedent for such an approach at the firm/customer level. A two-pot model does not eliminate the insolvency issues created by the cross-margining of securities and futures products. Rather, it requires the development of a method by which funds and property

[5] Exchange Act Release No. 34-41766 (Aug. 19, 1999).

can be moved across the jurisdictional boundary from the segregated funds pool to the securities customer property pool and vice versa—a mechanism which does not exist in SIPA, the CEA, the Bankruptcy Code or the CFTC's Part 190 Rules. Without further study, we cannot conclude whether or not such a mechanism could be devised and implemented without statutory amendments or which statutes might need to be amended, but we do note that no proponent of a two-pot approach has put forward any concrete proposal as to how it would work. In contrast, the path forward to implementation of a one-pot approach in a securities account is relatively clear. We believe, as stated below, that only two significant regulatory actions should be required.

Further, as a practical matter, a two-pot approach would need to be implemented not only at the firm level, but at the clearing level as well. The two-pot approach at the clearing level involves a system of uncollateralized cross-guarantees between (or among) the participating clearing organizations rather than a commonly held pool of collateral as in the one-pot approach. It would require a significant policy decision for any clearing organization to agree to accept this degree of uncollateralized risk exposure to another clearing organization. This decision becomes further complicated once consideration is given to differences between the clearinghouses' respective margin methodologies and model inputs. On the other hand, the existing cross-margining program between OCC and CME, which was developed jointly by our two clearing organizations, has worked extremely well for many years and can easily be used with virtually no substantive change to accommodate cross-margin accounts in the Pilot Program.

We do not believe that it is either necessary or desirable to attempt to put in place a cross-margining program that is a compromised half measure. We are concerned that the two-pot approach, even if it is ultimately deemed to be feasible in this context, will require a significant investment for both the firms and the clearing organizations in order to develop and operate a system that few, if any, participants believe is optimal from either a risk management or operational perspective.[6]

We understand and respect the fact that both CME and the CFTC as well as some FCMs may have concerns regarding the carrying of futures products in a securities account. For example, a CME representative as well as a futures industry representative have expressed concern that futures products that are no longer hedging securities

[6] Many if not most of the firms that are expected to be most active in the cross-margining programs already have in place systems that are capable of determining risk, setting collateral requirements and handling the other operational aspects of carrying both securities positions and futures products in a single account. These capabilities are already necessary for handling security futures products as well as doing business in jurisdictions outside the United States. A two-pot approach, on the other hand, will for many firms require the development of systems that can combine a futures and securities account for purposes of determining a margin requirement—a task that is generally not performed today by most firms. This may result in the need for multiple margin calculations and entail additional operational overhead associated with the ongoing transfer of assets between the two accounts in order for the firm to avoid incurring undermargined account capital charges or meet funding requirements in either the segregated funds pool or the 15c3-3 reserve account. These are novel problems for which no solution has been developed.

positions in a portfolio margin account would have to be immediately transferred out of the portfolio margin account and into a segregated funds account under circumstances that would create a risk of under-segregation in the segregated funds pool.[7] Commission staff commented that, although it is not intended that a portfolio margin account would be permitted to operate as a substitute for a segregated funds account in which futures products could be carried without any relationship to securities positions in the portfolio margin account, it was also not intended to impose a harsh rule that would require immediate transfer of positions without collateral. Concerns have also been expressed in a general way that, by permitting futures products to be carried in a securities account, the CFTC would be relinquishing important regulatory control beyond simply permitting the products to be carried outside the segregated funds/FCM liquidation provisions. We do not believe that this is a necessary consequence. We have discussed briefly below the question of the CFTC's authority to exempt futures products from the segregation requirements of the CEA in order to permit them to be carried in a securities account, and we note that this authority to exempt also includes the authority to impose conditions upon such an exemption. While we recognize that the CFTC would not want to relinquish any of its authority to regulate trading in the markets subject to its jurisdiction, we strongly believe that any relief given with respect to the segregation requirements could be sufficiently narrow to avoid any such concern.

Finally, we would like to address another issue that is sometimes raised—inappropriately we think—in this context. The SEC has indicated that, at present, OCC's TIMS model is the only approved model for portfolio margining. The CME's comment letter describes the CME's own SPAN model, which it believes should be an approved model for cross-margining. In addition, we note that the comment letter recently submitted by the Securities Industry Association suggests that each firm should be allowed to use its own proprietary risk-management models so long as they are developed under an approved model policy.[8] We wish to emphasize that the question of which model or models should be used for the determination of portfolio margin requirements is a question that is entirely independent of and unrelated to the question of a one-pot or two-pot model or whether futures are carried in a securities account or not. A model will need to be used to determine the cross-margin requirement on combined futures and securities positions regardless of whether the futures are in the same or a separate account, and the model or models will need to be approved for this purpose by the Commission staff. Accordingly, questions of which model is to be used should be set aside for purposes of the present discussion.

[7] These comments were made by participants in a panel on portfolio margin issues presented on May 11, 2006 at a conference of the Futures Industry Association's Law & Compliance Division.

[8] See letter dated May 16, 2006 to Nancy M. Morris, Commission Secretary.

Regulatory Action Needed to Implement a One-Pot/Securities Account Model

Prior to the Commission's approval of the Exchanges' rule filings establishing the original Pilot Program, OCC filed a comment letter, dated May 27, 2005, pointing out certain regulatory actions that needed to be taken in order to implement the cross-margining provisions of the Pilot Program. Some of those actions have already been taken by the Commission, but two necessary regulatory actions remain to be done—one requiring action by the Commission and one requiring action by the CFTC. They are as follows:

- Absent relief from the CFTC, Section 4d(a)(2) of the CEA would require that all futures products be carried by an FCM in a segregated futures account, and would prohibit the carrying of futures products and related customer property in a portfolio margining account regulated as a securities account and commingled with property other than the segregated funds of other futures customers. In order to facilitate cross-margining in securities accounts, the CFTC would therefore need to issue a rule or order exempting futures products in such accounts from the provisions of Section 4d(a)(2). We believe that there is clear authority for such relief in Section 4(c)(1) of the CEA, which permits the CFTC to "exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to [the exchange trading requirement of subsection (a) of Section 4 of the CEA] from the requirements of subsection (a), or from any other provisions of [the CEA, with specified exceptions not relevant here]. Section 4(c)(2) of the CEA then sets conditions to the exercise of such exemptive authority, which we believe could easily be met in the context of portfolio margining.[9]

- The Commission needs to move forward with its proposed release (the "Rule 15c3-3 Release") in which, by amendment to Rule 15c3-3, the Commission would seek to ensure that a cross-margining customer would have a claim as a securities customer and would not be relegated to the status of a general creditor to the extent that the customer's net equity claim arises from positions in futures or futures options in the portfolio margin (or

[9] Section 4(c)(2) provides that the CFTC shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) [interestingly, the provision does not on its face impose this prohibition on exemptions from other provisions of the CEA] unless the CFTC determines, in essence, that the exemption is appropriate and consistent with the public interest and that the transactions to which the exemption relates will be entered into between "appropriate persons." "Appropriate person" is defined in paragraph (c)(3) to include "other persons that the [CFTC] determine to be appropriate in light of their financial or other qualification , or the applicability of appropriate regulatory protections." Assuming for the present purpose that the "appropriate person" requirement would be applicable to an exemption from segregation rules, the requirements of being an "eligible participant" in a portfolio margin account and the fact that these accounts would be subject to the regulatory protections afforded securities customers in a securities account should leave no room to challenge the reasonableness of a CFTC determination that an "eligible participant" is an "appropriate person."

cross-margin) account. Section 16(4)(B) of SIPA defines "customer property" to include "resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule." It is our understanding that the Rule 15c3-3 release would use this definitional authority to amend Rule 15c3-3 to provide, in effect, that resources provided through the liquidation of futures or futures options in a customer's cross-margining account would be included in the pool of customer property. It is our understanding that, as a backstop to the action to be taken by the Commission in the Rule 15c3-3 Release, efforts are underway to obtain a narrowly crafted amendment to SIPA in order to explicitly address the carrying of futures products in a portfolio margin account regulated as a securities account. We nevertheless urge the Commission to move forward with the Rule 15c3-3 release in order to allow cross-margining to be implemented pending the adoption of statutory amendments.

We also would be pleased to participate in discussions with representatives of the CFTC, the CME and other interested parties to resolve the issues addressed in this letter. We hope that the forgoing comments are constructive in moving toward the widely shared goal of a comprehensive portfolio margining program that places U.S. financial intermediaries on an equal competitive footing with their foreign competitors. While we have candidly shared our views with respect to the relevant issues, we are open to discussion of all possible alternatives to achieve a result that is in the best interests of the financial community that we serve.

Sincerely,

William H. Navin /mmp

William H. Navin
Executive Vice President & General Counsel

WHN:mmp

cc: Michael Macchiaroli, SEC
Jerry Carpenter, SEC