TESTIMONY OF MEYER S. FRUCHER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
PHILADELPHIA STOCK EXCHANGE

ON BEHALF OF

THE U.S. OPTIONS EXCHANGE COALITION

American Stock Exchange
Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
Pacific Exchange
Philadelphia Stock Exchange
The Options Clearing Corporation

EXAMINING THE
COMMODITY FUTURES MODERNIZATION ACT OF 2000
AND RECENT MARKET DEVELOPMENTS

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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I am Meyer S. Frucher, Chairman and Chief Executive Officer of the Philadelphia Stock Exchange ("Phlx"). I appear today on behalf of the Philadelphia Stock Exchange and the five other United States options markets: the American Stock Exchange, the Boston Options Exchange, the Chicago Board Options Exchange ("CBOE"), the International Securities Exchange, the Pacific Exchange, and our clearinghouse, The Options Clearing Corporation. Together, we comprise the U.S. Options Exchange Coalition. Our markets trade all the exchange-traded security options in the U.S., such as options on individual stocks, stock indexes, exchange-traded funds, debt securities, and foreign currency. These markets provide the major hedging instruments for the U.S. stock market. The U.S. Options Exchange Coalition welcomes this opportunity to provide its views on reauthorization of the Commodity Futures Trading Commission ("CFTC").

We welcome the Committee on Banking, Housing and Urban Affair's participation in CFTC's reauthorization. The Committee has an important role to play in the issues under consideration because of its oversight of three of the four members of the President's Working Group on Financial Markets ("President's Working Group") — the Department of the Treasury, the Federal Reserve Board and the Securities and Exchange Commission — as well as its jurisdiction over securities and over-the-counter derivatives. As a part of the

reauthorization, the Senate Committee on Agriculture, Nutrition, and Forestry recently reported S. 1566, the Commodity Exchange Reauthorization Act of 2005, to re-authorize the CFTC. This bill touched on a number of issues within the Banking Committee's jurisdiction. The U.S. Options Exchange Coalition is focused on one aspect of the CFTC reauthorization and S. 1566 — the treatment of security futures products (*i.e.,* futures on individual stocks and narrow-based stock indexes).

The U.S. Options Exchange Coalition's interest in the CFTC reauthorization is to maintain the competitive balance between security futures and security options established by Congress in 2000 in the Commodity Futures Modernization Act ("CFMA"). S. 1566's provisions dealing with security futures would destroy this balance by removing the consistent margin treatment between security options and security futures. The U.S. Options Exchange Coalition has a proposal that would preserve this balance while hastening the use of risk-based portfolio margining for both security futures and security options. We urge the Committee to endorse the principle of regulatory parity between security futures and security options as it moves forward with CFTC reauthorization.

In the U.S. Options Exchange Coalition's view, security futures and security options should be regulated in a consistent manner in order to preserve competitive fairness. Congress made consistent regulation

the cornerstone of the Congressional compromise that led to the CFMA and the introduction of security futures trading. Nothing has occurred since the enactment of the CFMA that should lead Congress to change this policy of regulatory parity between security futures and security options. As discussed in detail below, our proposal would maintain this important objective while providing margin relief for security futures and security options. To accomplish this, our proposal would direct the SEC and CFTC to adopt rules within nine months permitting consistent portfolio margin treatment for both products. We strongly urge Congress to follow our approach.

The CFMA Was Enacted Based Upon Consistent Regulation

During consideration of the CFMA, Congress reviewed whether and how security futures products should be permitted. Prior to the CFMA security futures had been prohibited since an SEC-CFTC jurisdictional accord in 1982. Futures on broad-based stock indexes were permitted, but not futures on individual stocks or on a narrow-based index of securities. The prohibition emanated from a lack of consensus on whether to regulate these products as securities or futures. In 1999, in anticipation of CFTC reauthorization, the President's Working Group advised Congress that futures on individual stocks and narrow-based indexes should be permitted to trade if they were appropriately regulated. Appropriate regulation of the product was

based on the fact that futures on individual stocks and narrow-based indexes had characteristics of both securities and futures.[1]

When the CFTC came up for reauthorization in 2000, the futures industry advocated a removal of the prohibition on futures on single stocks and narrow-based indexes and options on such futures (collectively called security futures products). While the U.S. Options Exchange Coalition did not object to the introduction of security futures products, it urged Congress to ensure that these products be regulated in manner that provides a level playing field with security options. Consistent with the President's Working Group's findings, the U.S. Options Exchange Coalition argued that security futures are not traditional futures products but are functionally and economically equivalent to security options. As a result, appropriate regulation of these products must include a role for the SEC and key elements of securities regulation. The U.S. Options Exchange Coalition and SEC noted that regulation of security futures solely as futures would pose risks for the securities markets and investors and would create competitive inequities.

In general, the securities laws are designed to protect investors, provide full disclosure of corporate and market information, and prevent

[1] See, Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets, November 1999. The President's Working Group noted that "the current prohibition on single stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved."

fraud and manipulation. The commodities laws are designed to facilitate commercial and professional hedging and speculation and to oversee the price discovery process. Because of the different emphases of the two regulatory schemes, many of the basic regulatory protections that apply to each are very different. The U.S. Options Exchange Coalition, along with the SEC, argued that it would be a mistake to simply impose the futures regulatory model onto a class of products that are the functional equivalent of products regulated under the U.S. securities model.[2] Instead, the U.S. Options Exchange Coalition urged Congress and the SEC and CFTC to determine how to apply relevant portions of the securities regulatory structure to security futures products when lifting the prohibition on these products. Our views were consistent with those of the SEC and the securities industry.

Congress agreed with the U.S. Options Exchange Coalition's position that security futures should be subject to elements of securities regulation. As a result, the SEC and CFTC, under the direction of the relevant Congressional committees, negotiated for many months on a regulatory structure for security futures products. The SEC/CFTC negotiations led to an approach that would regulate the products as both securities and futures under the oversight of both agencies, but with

[2] See, e.g., Testimony of William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, on behalf of the U.S. Securities Markets Coalition, before the Subcommittee on Risk Management, Research and Specialty Crops, U.S. House of Representatives, Regarding the President's Working Group Report on OTC Derivatives and the Commodity Exchange Act, February 15, 2000.

exemptions in certain areas to prevent duplicative regulation. Congress enacted this approach in the CFMA.

A major component of the dual regulation approach was that security futures would be regulated in a manner consistent with comparable security options in key areas, such as insider trading, margin, tax, and transaction fees, in order to provide regulatory parity between these two product groups. Consistent regulation prevents regulatory arbitrage and promotes competitive fairness for equivalent products. It also avoids market anomalies where participants transact in a product to avoid the regulations of an equivalent product rather than for economic or commercial considerations. Indeed, regulatory consistency between security futures and security options was the linchpin of SEC/CFTC agreement for regulating security futures. Without it, the U.S. Options Exchange Coalition, securities markets, SEC, and Congressional securities oversight committees would not have supported the introduction of security futures products.

One of the most important areas of regulatory consistency embodied in the CFMA involved margin. Margin has an important function in derivative contracts. It not only acts as a performance bond but also directly controls the amount of leverage in a derivative such as a security future or a security option. It thus acts to affect the cost of establishing and maintaining a position in the derivative. As security futures and security options are economically equivalent instruments,

different margin levels would have a significant impact on the competitive balance between the two products. To ensure a level playing field, the CFMA placed provisions in the Commodity Exchange Act and Securities Exchange Act of 1934 that required security futures margin to be consistent with the margin for comparable securities options. After passage of the CFMA, the SEC and CFTC approved security futures products trading with 20% margin, the same margin required for security options.

The Current CFTC Reauthorization Should Maintain Regulatory Consistency

Since their introduction, security futures products have had a slow start. While transaction volume and open interest in these products has grown substantially over the past year, trading interest still remains relatively small. Some of the futures exchanges along with the CFTC have questioned whether the dual regulatory approach has burdened security futures products, and in particular, whether the application of 20% margin has hampered the growth of the product. As a result, the Chicago Mercantile Exchange ("CME") offered a proposal for a program that would leave margin setting authority for security futures products solely with the futures exchanges, subject to residual oversight by the Federal Reserve Board ("Federal Reserve"), and suspend SEC and CFTC oversight of margin for these products. The Senate

Agriculture Committee adopted that approach in reporting S. 1566. The U.S. Options Exchange Coalition believes that approach to be seriously flawed because it would end the consistent margin treatment of security futures and security options. Instead, the U.S. Options Exchange Coalition has developed a proposal that would offer margin relief to security futures and security options while maintaining consistency of treatment across these two product groups.

As a preliminary matter, the U.S. Options Exchange Coalition notes that it supports efforts to attract new business to security futures products. While these products compete directly with securities options, they also are complementary to them. Security futures offer our markets opportunities for hedging and arbitrage, and likewise participants in the securities futures markets use security options for hedging and arbitrage. There are a number of reasons why security futures have not yet been a huge success: their introduction several years ago during a brutal bear market; robust cash equities and options markets that diminish the utility of the products;[3] and the reluctance of broker-dealers to actively market the product to their customers. It is doubtful that margin treatment is a major reason for the lack of success of security futures. After all, with

[3] Security futures products are offered in a number of countries. For the most part, this product has not garnered much trading volume. In the few countries where securities futures products have encountered success, the country either lacks a very liquid underlying market (so that the futures market becomes more desirable as a mechanism for transactions) or the country imposes tax or other fees on stock trading and not on futures trading (so that persons use futures as a means to avoid these taxes or fees).

the same margin, security options have experienced record volumes over the past few years.[4] It is also important to understand that more new futures and options on futures products fail than succeed.[5]

Nevertheless, we are sympathetic to the desire of the futures industry to implement portfolio margining for security futures products. In many cases, the current strategy-based margin system for security futures and security options results in collecting more margin than is necessary to prudently protect against potential losses.[6] This over margining is an inefficient use of capital by both security futures and security options customers. However, implementing portfolio margining for security futures must be accomplished in a manner that upholds the framework of regulatory consistency between security futures and security options. We strongly oppose unilateral efforts to reduce margin regulation of security futures without granting consistent treatment for security options. That is why we oppose the security futures margin provisions of S. 1566. By leaving securities futures margin solely up to

[4] Listed security options had an average daily trading volume of 2,883,841 contracts in 2000, 4,690,635 contracts in 2004, and 5,571,704 contract for the first six months of 2005.

[5] For example, since 1995, the CME has filed to trade 293 new futures and options on futures contacts. On July 7, 2005, only 32 of these products had any trading volume on that date. Of those, only 10 had trading volume of 1,000 or more contracts.

[6] Under a strategy-based margin system, each option position must be classified as a covered write, spread, straddle or naked long or short position, etc. Once separated into the individual strategy positions, which can be a cumbersome process, margin is calculated separately for each paired off position, or naked position as the case may be, without consideration of any other positions that might further offset the risk of that position. Each strategy has a standard formula for computing the margin requirement that applies to all option classes.

the futures exchanges, the bill would sever the consistent treatment with securities options which has existed since the introduction of security futures. Security options margin would still be subject to SEC oversight, but security futures margin would have no SEC (or CFTC) oversight whatsoever.

The bill, as reported, would undo the carefully drafted compromise embodied in the CFMA, is unfair to security options, and is unnecessary to achieve the desired results. It is a certainty that if S. 1566 were enacted, the futures exchanges would reduce the margin for security futures products far below a level that the SEC would approve for security options, perhaps as low as 5%. This would place security options at a large competitive disadvantage to security futures, which is the precise situation that Congress in enacting the CFMA sought to avoid. Given this disparity in margin levels, customers may choose security futures over security options not because of the merits of the product but merely because of its lower cost. S. 1566 unnecessarily puts Congress in the position of granting regulatory advantages to one industry over another.

The U.S. Options Exchange Coalition has developed an alternative approach that would lead to risk-appropriate portfolio margining for both products in a manner that would preserve the consistent treatment endorsed by Congress in the CFMA. We have shared this approach with the SEC, CFTC, CME, and Congressional committees. Under the

approach, Congress would direct the SEC and CFTC to adopt joint rules permitting the use of portfolio margining for security futures within nine months of passage of the legislation, and also direct the SEC to adopt a consistent rule permitting the use of portfolio margining for comparable security options within nine months of passage of the legislation.[7] Portfolio margin treatment allows instruments' (stocks, bonds, options, and futures) margin to be based upon the aggregate risks of all such instruments in a person's portfolio. Because a portfolio margining system would calculate margin on the greatest loss that could occur in a portfolio if the value of component instruments moved up or down by a certain amount, it is a more precise and efficient margin treatment than the current strategy-based approach used for security options and security futures. It is likely that, in many cases, a portfolio margin approach would reduce the amount of margin needed for security futures and security options for customers while still maintaining adequate risk coverage.[8]

[7] While the Federal Reserve ultimately has authority over securities margin, several years ago it delegated its authority over listed security options to enable the margin for these products to be set by the rules of the options self-regulatory organizations ("SROs") subject to approval by the SEC. Our proposal would direct the SEC, as long as the delegation from the Federal Reserve continued, to pass a rule that permits the SROs to allow portfolio margining of security options.

[8] While the Coalition proposal specifically addresses portfolio margin for security futures products and security options, the joint rulemaking as well as the separate SEC rulemaking would be free to include other related instruments such as stocks and broad-based stock index futures in a portfolio margin program.

The U.S. Options Exchange Coalition's legislative proposal is consistent with the approach to margin Congress laid out in the CFMA in 2000. Congress gave the Federal Reserve authority over margin for security futures and the ability to delegate this authority to the SEC and CFTC jointly. In delegating margin authority, the Federal Reserve encouraged the agencies to move toward portfolio margining for security futures.[9] Indeed, portfolio margining has been used at the clearinghouse level for security options for many years. In addition, markets in many foreign countries already employ portfolio margining for futures and options, as do most U.S. futures exchanges for products other than security futures. It is a time-tested international methodology, and it is imperative and urgent that the U.S. securities regulatory structure catches up to the rest of the world in using it. Unfortunately, progress toward this goal has been slow and incremental. Recently the SEC approved a proposal to implement a two-year pilot program to allow portfolio margining for listed broad-based stock index options, index warrants, and related futures and exchange traded funds ("ETFs")[10]. It took the SEC three years after submission of a formal proposal to grant this approval. While the pilot program would have been a good first

[9] Letter dated March 6, 2001, from Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, to Mr. James E. Newsome, Acting Chairman, CFTC, and Ms. Laura S. Unger, Acting Chairman, SEC.

[10] Securities Exchange Act Release Nos. 51615 (April 26, 2005) and 52032 (July 14, 2005).

step several years ago, it is time to move beyond an incremental approach toward the type of comprehensive methodology employed elsewhere that covers a wide range of products and market participants.[11]

Our proposal would accomplish this by mandating that rules permitting portfolio margin for security options and security futures be adopted by a date certain, while preserving the consistent margin treatment between the two product groups. This proposal would produce a win-win situation for security futures and security options markets and compel the SEC and CFTC to act swiftly toward this important goal. The nine-month period for rulemaking in the proposal is appropriate, as much of the preliminary work has already been accomplished. The futures industry and CFTC are very familiar with portfolio margining and the securities industry has been working with the SEC over the past few years toward obtaining portfolio margining for securities. This should be a familiar territory for both agencies. The SEC could build upon and expand the broad-based stock index options pilot to adopt rules for all security options and work with the CFTC to adopt consistent rules for security futures. With new leadership at the

[11] While the broad-based index options pilot was approved as a first step, it has overly restrictive provisions as to the accounts eligible to use portfolio margin. A comprehensive rule for portfolio margin should not restrict its use to accounts with very high equity or high net worth institutions. Rather, it should accommodate a wide range of entities that want to use portfolio margin, as is the case for portfolio margin in many foreign markets and in the futures industry.

SEC and CFTC and clear direction by Congress, we believe the two agencies could act quickly to adopt comprehensive rules that would benefit investors and the markets.[12]

In permitting portfolio margining, it is critical that the SEC and CFTC adopt joint rules for security futures and that such rules are consistent with the SEC rulemaking for security options. Due to the historically disparate approach between the SEC and CFTC toward regulation in general and margin regulation in particular, individual rulemaking by each agency would produce different results for comparable products under their jurisdiction. Only Congress can ensure fair and consistent treatment on this fundamental issue by mandating joint rulemaking for security futures and by directing the SEC to adopt the same rules for security options. The SEC and CFTC worked together to adopt rules to facilitate the introduction of security futures after passage of the CFMA. There is no reason why they could not do the same for portfolio margining. The U.S. Options Exchange Coalition and its members stand ready to provide whatever assistance is needed to the SEC and CFTC to adopt rules for portfolio margining as well as to Congress as it deliberates on margin-related issues.

The U.S. Options Exchange Coalition's legislative proposal also contains definitional changes to the Securities Investor Protection Act of

[12] The Coalition suggests that Congress require a brief status report in the nine-month rulemaking period to make sure that the two agencies remain on track.

1970 ("SIPA"). SIPA involves the activities of the Securities Investor Protection Corporation ("SIPC"). SIPC protects customers if a broker-dealer goes out of business up to specified amounts for customer cash and securities at the broker-dealer. SIPC covers most types of securities, but does not cover certain futures. Changes to SIPA are needed to accommodate portfolio margining by security options customers. Optimally, portfolio margining looks at all related positions in an account to determine the risk of the portfolio and the appropriate level of margin. For example, to fully realize the benefits of the portfolio margining pilot recently approved for options on broad-based stock indexes and ETFs, a customer may choose to have these positions in the same account as positions in broad-based stock index futures and futures on ETFs. Margining of options and futures in one account is called cross-margining. To facilitate cross-margining for such a customer, narrow changes to SIPA are needed to make sure that the customer is protected in the unlikely event of a broker-dealer bankruptcy. These changes would permit the cross-margin accounts of qualifying customers to be treated as "securities accounts" under SIPA and provide that such customers can have appropriate claims against customer property consisting of certain futures in the event of the insolvency of the carrying broker-dealer.[13] Without these changes, portfolio

[13] For example, the definition of customer property under SIPA needs to be amended to include certain commodity futures and commodity option contracts.

margining cannot be fully implemented and inefficiency in the margining of securities will remain. The U.S. Options Exchange Coalition has discussed these changes with the SEC and the CFTC. It is crucial that Congress adopt these changes as part of the CFTC reauthorization process.

Broad-based Index Definition

The CFTC reauthorization touches upon a variety of other issues, such as CFTC jurisdiction in foreign currency markets. The U.S. Options Exchange Coalition does not have a position on most of these other issues. However, the U.S. Options Exchange Coalition does have an interest in potential changes to the definition of narrow-based security indexes. The CFMA contains definitions of narrow-based security indexes in order to differentiate a narrow-based security index future from a broad-based security index future. Narrow-based security index futures are treated as security futures products and are subject to the dual jurisdiction of the SEC and CFTC, while broad-based security index futures are subject to the exclusive jurisdiction of the CFTC. These important definitions were carefully crafted by the SEC and CFTC.

The CFTC and others in the futures industry want to create new definitions for "narrow-based security" indexes based on United States debt instruments, other United States securities, foreign equities, or foreign debt instruments. These new definitions for narrow-based

security index for the four product types noted above could result in differences from the same definition applicable currently to an index comprised of U.S. equities. The U.S. Options Exchange Coalition will defer to the judgment of the SEC as to whether such differences would lead to an undesirable result in this area. In any event, the definitions of narrow-based security index should be crafted by the SEC and CFTC *jointly*. While there should be a good reason for any deviation from the definitions adopted by the CFMA, we will defer to the judgment of the two agencies if they jointly decide that the changes are warranted.

Conclusion

The U.S. Options Exchange Coalition believes that CFTC reauthorization provides an opportunity to bring the benefits of portfolio margining to both security futures and security options in a manner that maintains the CFMA's parity of treatment for security futures and security options. The U.S. Options Exchange Coalition's proposal provides the means for achieving these goals. S. 1566 does not do so. We urge the Committee to maintain the parity of CFMA during reauthorization.

Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions that you have.

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