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Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
2033 K Street, N. W.
Washington, D. C. 20581

Dear Ms. Webb:

The Chicago Board of Trade (CBT) and the Chicago Mercantile Exchange (CME) have filed petitions for rulemaking to delete Regulation 33.4(a)(2) of the CEAct and Regulations thereunder. Deletion of such Regulation would allow commodity option positions to be margined on a "futures-style" basis, eliminating the existing requirement that option customers must pay the entire amount of the option premium at the time of purchase. In FR 54:21, pages 11233 - 11236, dated March 17, 1989 the Commodity Futures Trading Commission (CFTC) has requested comments on the referenced topic. The Chicago Board Options Exchange (CBOE) hereby submits the following comments in this regard.

<u>Issues</u>

In assessing the petition for rulemaking filed by the CBT and CME the CBOE wishes to raise three issues.

(1) The Exchange certainly shares the expressed concerns for cash flows and system liquidity, particularly during periods of high market volatility such as occurred in October of 1987. However, the CBOE believes that policy responses to liquidity problems require recognition that stocks, index futures, and options represent a single market. In particular, the Exchange advocates implementation of cross-margining between stocks, index futures and options, rather than a piecemeal application of futures-style margining in one portion of the financial marketplace.

(2) The CBOE is concerned about the possibility for customer confusion arising both from the transition to futures-style margins and from the resulting difference between margin systems prevailing on the securities markets and those which would be in place for contract markets. It is not clear that either cash flow gains to market professionals or alleged liquidity gains to market participants are sufficient to justify the potential confusion among option customers.

(3) The CBOE notes that in the 18 months following the October market break the level of margins required for equity index futures has returned to the levels required prior to the events of October 1987. These pre-market break levels of margin required on futures positions were criticized by some observers as contributing to problems of cash flow and panic selling during the market break. Futures option margins are already linked to the level of futures margins. However, under the CBT and CME proposals this linkage would become even stronger. In granting or denying the petitioners request for rulemaking the CFTC will also be sending a message to market participants, both retail and institutional, regarding the assessment by regulatory agencies on the adequacy of futures margin levels as well as the process by which such levels are established.

Margins and the Integration of Financial Markets

Virtually every commission and task force that examined the events of October 1987 expressed concerns regarding the fragmented and inconsistent nature of margining and clearing systems in the financial markets. In fact, the Presidential Task Force believed that "the complexity and fragmentation of the separate clearing mechanisms in stocks, futures and options...brought the financial system to the brink on Tuesday, October 20." The staff report of the Securities and Exchange Commission, while generally positive in its assessment of the margin and clearing procedures during the market break, also emphasized the difficulties arising in large part from the differing clearing and margining systems for stocks, futures and options markets. Of course, the liquidity problems resulting from the lack of integration in margin and settlement procedures were a significant impetus for the actions taken by the Federal Reserve during the week of October 19, 1987.

The lesson of the October market break was the lesson underlined by the Presidential Task Force - "that stocks, stock index futures, and stock index options compose, in an economic sense, one market." No commentator on the October 1987 events has disputed this claim. However, despite widespread agreement on the "one market" formulation, there has been limited effort to develop policies and procedures that recognize this reality and seek to simplify the complexity of inter-market cash and information flows. The CBOE believes that implementation of cross-margining between stocks, index futures and options should be the primary policy goal of the regulators of both contract markets and securities markets. The result would be more efficient and liquid markets, benefiting customers and professional market participants alike. If futures-style margining for commodity options (and/or other instruments) contributes to the efficient achievement of cross-margining in the financial system as a whole, then it may make sense to implement this policy. However, it appears more appropriate for this decision to be reached after an assessment of the policy and procedural changes necessary to achieve cross-margining throughout the financial marketplace, rather than as a piecemeal approach that creates margin consistency between two instruments contained within a single segment of the financial marketplace.

It is true that futures-style margining would largely resolve cash flow problems associated with variation payments on contract markets, an issue not directly addressed by cross-margining. However, in the absence of cross-margining, futures-style margins would have relatively limited impact on systemic cash flow crises associated with periods of high market volatility. For example, the liquidity problems resulting from the dramatic increases in initial margins imposed by contract markets during October 1987 would not be mitigated by the petitioners proposal for futures-style margins. In fact, the reverse would probably have been more likely. In contrast, cross-margining of hedged positions would free credit lines by reducing the drain of initial/maintenance margin requirements for such positions. Further, cross-margining would likely increase the credit available to finance variation payments on inter-market hedges. Cross-margining is thus the more comprehensive and efficacious policy choice, impacting all facets of systemic cash flows without disrupting the clearance and settlement systems, increasing member firm costs, or customer confusion.

The Exchange recognizes that implementing cross-margining would require cooperation between contract markets, U. S. stock markets, securities options markets such as the CBOE, and their associated clearing entities. Such cooperation between markets that both compete with and complement each other requires leadership from the appropriate regulators, in particular the CFTC and the SEC. In the absence of such leadership, the CBOE is concerned that individual markets may pursue their own specific interests to the probable detriment of the financial system as a whole.

Do the Benefits Outweigh the Costs?

The major hypothesized benefit of implementing futures-style margining on commodity options is increased liquidity. It is stated that such increase in liquidity will occur because of a balancing of cash flows for professional market makers (see CBT Petition for Rulemaking, p2 and the Commission's Federal Register release) and that all option market participants will benefit therefrom. At the same time, the Commission has raised the question of potential customer confusion, arising both from the transition to futures-style options margins and in particular from the coexistence of stock-style and futures-style margining systems.

The enhancement of market liquidity is certainly a desirable goal and any reasonable steps that can be taken in order to enhance liquidity should be taken. However, the evidence does not support the petitions' contention that liquidity in options markets is significantly influenced by the margining system. The CBOE has traded stock-style margined options for more than sixteen years. Under this margining system option purchasers are required to deposit the full value of the premium at the time the contract is initiated and do not receive any increased value of the option except by liquidation or exercise. Exchange market makers have been able to develop deep, efficient, and liquid markets in a large number of option classes. In fact, with less than six years of trading history, the CBOE's S&P 100 index option (OEX) has become the largest volume option traded on any securities or futures exchange, either domestic or foreign. The CBOE's S&P 500 option (SPX) is the third most active stock index option, surpassed only by the OEX and the XMI option traded on the American Stock Exchange. Both the OEX and SPX options are margined on a stock-style basis, strongly suggesting that any argument linking liquidity with margining system is incorrect.

To support their proposal for revamping the margining system for options the petitioners also cite the experience of the London International Financial Futures Exchange (LIFFE) where futures-style margins are applied to options. However, there is no evidence that the application of such margining system has enhanced the liquidity of LIFFE options; rather, as is the case domestically, the most successful LIFFE options are those in which the corresponding futures volume is significant. For example, for the period 1987 - 1988 LIFFE option contracts increased in volume on a year-over-year basis when the corresponding futures contract increased in volume; however, where LIFFE futures volume did not increase on a year-over-year basis, the corresponding option volume also failed to grow. Rather than supporting the case for altering margining systems, the CBOE believes the LIFFE experience supports the proposition that the difference between stock-style and futures-style margining systems is of very limited importance to the success or failure of a particular option.

If the proposal to revamp the margining systems for options were a costless one, or one whose costs were borne only by the petitioners, the inadequacy of the petitioners' increased liquidity argument would not be significant. However, there are significant costs involved in this proposal. These are not limited to the monetary costs of systems development. Of much greater importance is the potential for confusion resulting from the existence of two different margining systems for options traded in the U. S. Comparison of risk and reward parameters between option markets will be made more difficult rather than clarified by the continued existence of stock-style option margins at the CBOE, AMEX, etc, in conjunction with the implementation of futures-style option margins at the CME, CBT, etc.

Customers unfamiliar with the different regulatory frameworks governing contract and securities markets will be confused regarding the significance of option premium levels which will likely differ under the two margining systems. For example, if as suggested in the Commission's release, option premiums for futures-style margined options are higher than for stock-style margined options, an increased number of market participants may find uncovered short positions on the former markets attractive without fully understanding that the actual risk of the positions are no different than for stock-style margined options. The result could be an increase of risk in the financial marketplace, an outcome of substantially greater import than the possibility of a limited increase in option market liquidity.

The CBOE wishes to stress an additional possible cost of granting the petitioners request for rulemaking. The deletion of Regulation 33.4(a)(2) would <u>allow</u> commodity option positions to be margined on a futures-style basis. However, deletion of this regulation would not <u>require</u> any contract market to adopt futures-style margining for commodity options nor would a specific contract market be required to apply such margining system to commodity options on all products. Inconsistency between contract markets or between products, e. g. application to agricultural options but not financial options, would generate substantial customer confusion and increased firm costs. The result would be increased fragmentation of the financial marketplace rather than further integration as advocated by all analyses of the October 1987 market break.

<u>Margins - Risk and Collateral</u>

All margin systems are designed to provide funds sufficient for the perceived risk in a particular market and to serve as collateral against the positions taken by market participants. In the first instance margins are performance bonds; in the second instance margin levels determine the leverage possible with a particular instrument.

The CBOE recognizes the necessity for margins considerably less than 100 percent of the underlying instrument value in order to achieve the liquidity and immediacy desired by all market participants. Nevertheless, the Exchange notes that prior to the events of October 1987 maintenance margin levels on the most widely traded futures contracts represented less than 2 percent of the actual value of the component cash stocks. Leverage was thus in the order of 50:1. In contrast, leverage for at-the-money options was in the order of 10:1 (less for in-the-money options) and in the stock market was 4:1. The Exchange recognizes that the customer base differs in terms of financial sophistication between these markets and that the different pay/collect periods obviate naive calls for "equal" margins between stocks, options, and futures. However, a number of analysts of the October 1987 market break have suggested that the relatively low futures margins contributed to the crash in at least two ways.

First, the extent of leverage limited the financial cushion available to clearing houses. No reasonable system of maintenance margins would cover a move of more than 20 percent of the S&P 500 value as occurred on October 19, 1987. However, the failure of contract markets to significantly increase maintenance margin requirements in the weeks immediately prior to the crash, despite increased volatility, resulted in extremely large intra-day margin calls, contributing significantly to the cash flow problems experienced by the financial system. Further, the belated response to market volatility reflected in the tripling of initial margins by the CME after the crash worked at cross purposes to Federal Reserve efforts to increase liquidity within the financial system. Second, although less readily subject to documentation, the very high leverage factor of index futures may have encouraged holders of cash stocks to remain fully invested beyond levels that would normally occur. This then resulted in a stampede through the quite narrow egress of futures trading pit liquidity on the 19th.

The Exchange is recounting these facts not because there should be no difference in margin requirements on differing instruments. Rather, as noted in the introduction to this comment, the CME and CBT proposal would tightly link option margin requirements to those in effect on the underlying futures. In light of the concerns expressed regarding the events of the October market break is the Commission, as well as the Federal Reserve, confident that the margin setting mechanisms currently in place on contract markets are sufficient to insure no repeat of the cash flow problems exacerbated by such margins during October 1987? In addition, as noted in the Commission's Federal Register release, the default of Volume Investors was attributable to customer option positions. Is the Commission satisfied that sufficient safeguards are in place to prevent a repeat of the Volume Investors experience?

<u>Summary</u>

While the CBOE reserves judgement regarding the ultimate merits of futures-style option margining, the Exchange believes that it is a questionable policy choice at this time. "Rather than focusing myopically on a single market segment," the CFTC, SEC, contract markets, and securities exchanges should follow the recommendation of the Presidential Task Force on Market Mechanisms and seek implementation of cross margining which "allows margin regulations to focus on the true intermarket risk exposure of participants." Subsequent to the implementation of cross-margining the applicability, if any, of futures-style option margins to facilitating cash flows within the financial system should be determined and, where appropriate, applied in a uniform manner. The Exchange believes that the evidence supporting the alleged liquidity benefits of futures-style margins is so limited and ambiguous that any delay in implementing what may in the future be accepted as a desirable system is minimal. Finally, the CBOE also asks that the relevant regulatory bodies satisfy themselves that any implementation of futures-style option margins be done in a manner that does not threaten the overall integrity of the financial system.

Sincerely,

Alger B. Chapman

Alger B. Chapman
Chairman and
Chief Executive Officer