Confidential / Draft
3/7/05

Testimony of Martin Doyle, President, OneChicago LLC
Hearing on CFTC Reauthorization, March 9, 2005
Before the House Agriculture Committee
Subcommittee on General Farm Commodities and Risk Management

Mr. Chairman and members of the Subcommittee, I am Martin Doyle, President of OneChicago, LLC, the U.S. exchange for single stock futures and other security futures products. On behalf of OneChicago, our Chairman Peter F. Borish, and our joint-venture owners, we want to thank you for extending an invitation to us to present our views. I look forward to answering any and all questions you may have regarding single stock futures and OneChicago.

What is OneChicago?

OneChicago is a true product of the Commodity Futures Modernization Act of 2000. A main purpose of the CFMA was to "provide a statutory and regulatory framework for allowing the trading of futures on securities" by ending the almost 20 year statutory ban on U.S. trading in those instruments. It is no exaggeration to say that without this Subcommittee's work on the CFMA, OneChicago would not be here. We thank you and your predecessors for your work on that ground-breaking legislation.

By law, security futures are futures contracts on an individual security or a narrow-based securities index. Congress understood that these new forms of futures contracts could be attractive to mutual funds, hedge funds, pension funds, financial institutions and other investors who are either trying to manage their investment risk or assume a market view. Offering these products in an exchange-trading environment was thought to promote price transparency and liquidity in these products within a safe and financially-secure clearing system.

OneChicago is a joint venture of the Chicago Board Options Exchange Incorporated® (CBOE®), Chicago Mercantile Exchange Inc. (CME) and the Chicago Board of Trade (CBOT®). OneChicago trades only single stock futures and other security futures products. All OneChicago products are electronically traded on the CBOEdirect® match engine and accessible through the CBOEdirect and GLOBEX® platforms. All security futures can be traded through either a securities or a futures account.

OneChicago is a contract market designated by the Commodity Futures Trading Commission and is a notice registered securities exchange with the Securities and Exchange Commission. OneChicago is the only U.S. market in single stock futures and security futures products. And OneChicago offers a market only in those new investment products.

OneChicago's Start and Challenges.

OneChicago began trading on November 8, 2002, with 34 listings or futures on 34 stocks. Today, OneChicago lists 136 single stock futures contracts. All of the underlying stocks are included in the S&P 500, ranging from Apple and Boeing to Starbucks and Wal-Mart. We also offer futures contracts on seven narrow-based stock indexes[1] and one exchange traded fund (ETF) known as DIAMONDS.

Our progress has been steady. As with any new trading product, it has been a challenge to develop market momentum and liquidity. In 2003, our first full year, OneChicago traded 1,619,194 security futures contracts, which equates to an average daily volume (ADV) of 6,425 contracts. Our 2004 volume increased to 1,922,726 contracts for an ADV of 7,630.[2] While this does represent a 19% increase, our volumes and percentage gains pale when compared to those at overseas security futures exchanges. This situation is distressing to us, as we believe it will be to the members of this Subcommittee, especially since we know that one of the principal reasons Congress chartered single stock futures in the CFMA was to make sure U.S. markets could meet our foreign competition.

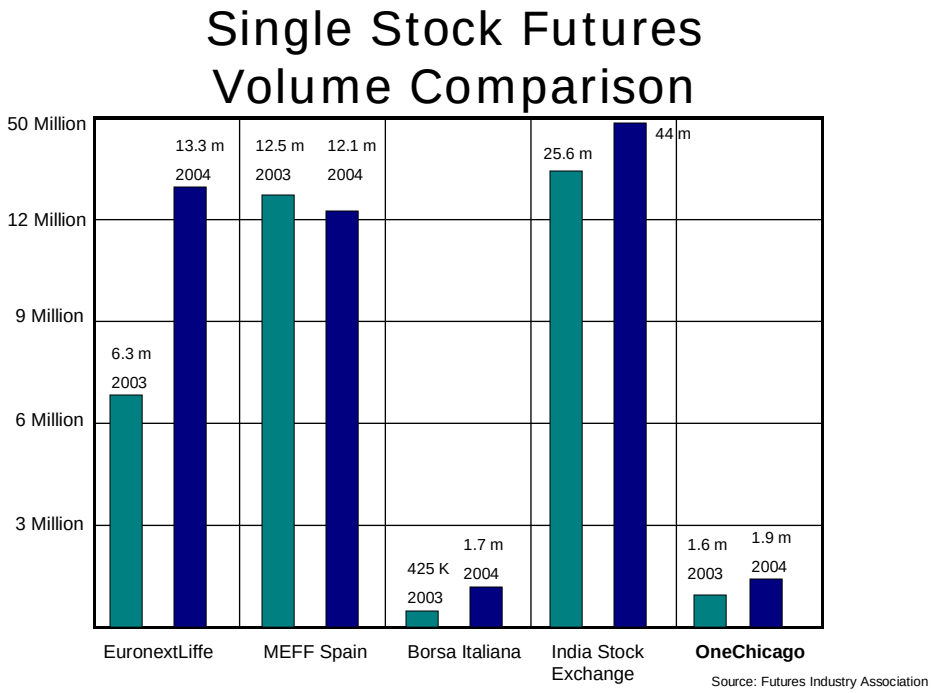
When Congress lifted the ban and authorized security futures products in 2000, security futures already had begun to be traded in foreign markets. We know this Subcommittee and others in Congress did not want to see U.S. markets fall behind those in England, Italy, Spain or India, among others. The U.S. is the home of financial innovation, the birthplace of financial futures trading. Having to play catch-up with foreign markets was not a desirable option for any one. Congress ended the ban and allowed us to offer security futures products in an effort to avoid having the U.S. markets trail those in other countries.

But look at the numbers from our foreign competition. Even accounting for their head start, their volume and growth are out-pacing us. Consider the following chart.

---

[1] We list futures on the Dow Jones MicroSector Indexes, which are narrow-based indexes of five highly correlated stocks within the same industry sector. OneChicago has made a strategic decision to delist these narrow based indexes following the March expiration to concentrate on single stock futures.

[2] Our open interest at OneChicago has consistently held between 150,000 and 300,000 contracts, depending upon where we are in the contract expiration cycle. As of Monday, March 7, 2005, we had 203,536 contracts in open interest, demonstrating to us that the product is indeed viable and that the financial community is interested in trading single stock futures. We have attached to this testimony a list of all of the contracts trading on OneChicago and our trading volume for the month of February, 2005.



As the chart shows, at the London based Euronext.Liffe exchange, 2004 single stock futures volume was up 114% over 2003 volume, with a total to 13.5 million contracts traded. And at Italy's Borsa Italiana, single stock futures volume rose more than 250% last year as it traded over 1.7 million contracts. At the Stock Exchange of India, 2004 single stock futures volume was up 72% to 44 million contracts, according to figures compiled by the Futures Industry Association. And finally, even at Spain's MEFF exchange, where single stock futures volume was basically flat, they were still able to trade 12.1 million contracts. As you can see, it is clear that at this time the security futures industry in the United States has not caught up with our competitors on foreign exchanges.

There are many potential explanations for these comparative volume and growth rates. But the fact remains that one area of difficulty that has compromised our ability to grow this market stems from certain aspects of the CFMA itself, and its implementation.

For that reason, our message to this Subcommittee is simple: "we need some help." We are starting a new business and offering a new product under special regulatory restrictions imposed by both the Commodity Futures Trading Commission and Securities and Exchange Commission. We have made a solid start. Like any new venture, there are things we have done well and things we could have done better. We have control over those business and operational issues. But we need your help with some of the regulatory and statutory hurdles.

We understand the reasons we are operating under some of these special constraints -- any new product involves many "unknowns" and is often greeted with regulatory caution and a list of well-intentioned "what ifs." OneChicago has no quarrel with the bulk of the regulatory framework or the good faith efforts of the CFTC and the SEC. While in a perfect world we would prefer a single regulator, we try to be realists. In a number of critical areas,

however, based on our now two-year experience with this new product, we believe the regulations and laws governing U.S. security futures markets could use some adjustment so that we may compete more effectively with foreign markets.

Some will counsel patience and state correctly that gaining market acceptance for any new product is a substantial challenge. In our case, that challenge has been magnified by the following phenomenon: before OneChicago's creation, U.S. financial market participants were using other available products to perform many of the same economic functions that security futures perform. Through these other products -- whether synthetic futures formed through combination of exchange-listed stock options, over- the-counter options or equity swaps and other forms of derivatives -- U.S. investors were finding ways to hedge stock price risks under existing regulatory rules. To attract those investors to our market, therefore, OneChicago had to convince our potential customers that there were advantages to shifting their business practices to trading a new product on a new exchange.

But OneChicago's new product also came with new regulatory strings attached. The CFMA treated single stock futures and security futures as a hybrid, part security, part option, part futures contract. Trading OneChicago's new products therefore required market participants to become comfortable and compliant with new regulatory rules and other legal requirements. Although many people worked very hard to try to smooth over the rough edges of this hybrid status, the fact remains that offering and trading OneChicago's products required market participants to adjust to a whole new set of legal rules of the road. This has inhibited our growth and development, as it would any new innovative product. Based on our experience to date, we would like the Subcommittee's help in removing some of these obstacles to market acceptance of security futures.

OneChicago's Recommendations.

Some of these obstacles would not involve statutory changes, and some would. In the non-statutory category, our concerns relate to two margin issues and one registration issue. In terms of margin, we have requested that the SEC and CFTC allow a regime of portfolio margining to apply to security futures. Portfolio margin assesses financial risk based on each market participant's portfolio of futures and options contracts, rather than on an individual contract or product basis. It takes into account the extent to which related contracts in different markets, for example, Treasury Notes and Eurodollars, or corn and soybeans, have price movements in common. It allows for more efficient use of margin capital without sacrificing, and we believe enhancing, financial integrity. The futures markets have utilized portfolio margin for many years. The SEC and CFTC stated in 2002 that in a six month period they would agree to a portfolio margin regime for security futures. More than two years later, we are still waiting. We would ask the Subcommittee to support the inclusion of committee report language in connection with the CFTC Reauthorization bill to encourage the agencies to move on this important initiative.

One source of liquidity for any market is its market-makers. Encouraging market making activity is therefore an important element in creating the critical mass of liquidity that is essential to narrowing bid-ask spreads that will be attractive to customers and to providing sufficient market depth so that investors who establish positions will know they can exit the

market efficiently and at a fair price. Market-makers also are not interested in maintaining positions with market exposure for extended periods of time, let alone overnight. For these reasons, market-makers typically enjoy special, lower margin requirements than other traders. OneChicago negotiated special market-maker margin rules with the SEC and CFTC. Unfortunately, those rules have proven to be more complicated and impractical to apply than anyone contemplated. We would like to see those rules streamlined and relaxed. OneChicago will be entering into discussions with the SEC and CFTC to achieve that purpose and to amend those rules. We would greatly appreciate the Subcommittee's support, perhaps again in Committee report language, in that endeavor.

Finally, an issue has arisen whereby CFTC-registered commodity trading advisors have been discouraged from directing trading toward the security futures markets because they fear they will be required to register as investment advisers with the SEC if they do. This legal uncertainty has had a chilling effect on participation by many financial institutions and other pools of investment capital. Again, we would appreciate this Subcommittee's assistance in obtaining a clear, bright-line test that allows CTA's to participate in security futures without fear of triggering SEC investment adviser registration.

In terms of statutory changes, we would recommend three changes, two of which are within the jurisdiction of the Agriculture Committee and one which is not. First, the level of initial and maintenance margin for security futures has been the subject of discussion from the very beginning. After much negotiation, the CFMA linked security futures margins to stock options margins, essentially at 20% of notional value. That level has proven, quite simply, to be unnecessarily high and has imposed an unwarranted cost that has discouraged new customers from using our products. While the agencies could allow for a reduction of the levels of margin without a statutory change, in light of the perceived sensitivity of this issue we would recommend that Congress amend the statute specifically to authorize margin levels at 15% of notional value. That level in almost all instances would satisfy the systemic risk and financial integrity concerns that generally animate margin-setting without imposing too high a barrier to entry of new positions.

Suitability is the next area. Generally, the futures industry operates under a "know your customer" rule and not a "suitability" rule as is applicable to securities markets. The CFMA requires futures commission merchants and other futures professionals to satisfy the same suitability requirements as they would have under the securities laws. As a substantive matter of customer protection, we do not believe there is a material difference in these two approaches. But fear of the unknown application of securities suitability standards has caused many futures firms to be unwilling to recommend or broker security futures trades. Since the real purpose of the CFMA's provision was to make sure customers are adequately protected and NFA's "know your customer" rule serves in every material respect the same customer protection purposes as a suitability rule, we would urge Congress to change the statute to allow futures professionals to meet either a "know your customer" or a "suitability" rule imposed by an SRO in dealing in securities futures.

Taxation is the last area. As this Subcommittee well knows, the special nature of futures trading has for many years justified a regime of 60-40 treatment for futures dealers. During the CFMA, one issue Congress considered was the proper tax treatment of gains and

losses from trading and market making in security futures contracts, including the extent to which 60/40 treatment should be accorded to dealers. Congress decided that dealers in security futures should receive 60-40 treatment. The definition of dealer in that context was left to the Secretary of the Treasury. Congress stated that the definition of security futures dealer should be made consistent with the generally recognized purpose of providing:

> "comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers."

H.R. Conf. Rep. No. 106-1033, 106th Cong., 2d Sess. 1036 (2000) (emphasis added).

Despite this guidance and despite the good faith efforts of all interested parties, the ultimate determination of dealer status for tax purposes was made in a way that is unduly complicated and gives securities futures less favorable treatment than is afforded to securities options. To remedy this disparity, OneChicago would recommend a bright-line test that allows all members of an exchange trading security futures to qualify for 60-40 tax treatment for their securities futures trading activity. In addition to achieving practical comparability with securities options, this approach would allow members of futures exchanges to experience the same tax treatment for security futures as they have for other futures trading activity.

Conclusion.

OneChicago thanks the Subcommittee for its interest in, and attention to, the development of a successful U.S. security futures market. We would greatly appreciate your consideration of our modest list of reforms to the regulation of our market which we believe will strongly serve the public interest and the national interest. We would be happy to answer any questions you may have.