



Via Electronic Submission

October 1, 2018

Christopher Kirkpatrick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street NW  
Washington, DC 20581

**Re: Position Limits and Position Accountability for Security Futures Products**

OneChicago, LLC (“OneChicago” or the “Exchange”) appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) request for public comment on the proposed rule for Position Limits and Position Accountability for Securities Futures Products (“SFP”). As the only domestic exchange listing SFP OneChicago has the clearest understanding of how security futures are used by market participants and we are happy to share our perspective. OneChicago commends the Commission for the willingness to review its regulations of these unique products and to seek guidance from the marketplace.<sup>1</sup>

Before discussing the proposal, OneChicago notes that position limits are unnecessary for SSF as strategy based margin with a minimum of 20% suppresses activity far more than position limits ever would. This year one of our largest and most loyal customers over the past few years – a customer attracted to our innovations – moved their business to Europe. They found a venue to copy our innovative product, they can continue trading the S&P 500 securities with physically settled contracts and they continue to trade with the exact same counterparties that we introduced them to. The customer did not leave due to position limits. They left because of the burden of the strategy based margin.<sup>2</sup> In Europe, they enjoy the US invention of risk-based margin.

OneChicago does not have strong feelings one way or the other about the Commission’s proposal because it will not significantly impact our market so long as margins remain at punitive levels. OneChicago does strongly believe that the Commission should understand the unique characteristics of our marketplace and the challenges our customers face. The Commission’s proposal exposes that they do not understand these challenges. This comment letter is intended to give the Commission the understanding it needs to properly regulate our marketplace.

**OneChicago Lists Derivatives**

What is common to all derivatives, whether they be a future, forward, option, swap, agreement, or arrangement is that they all determine their fair value by a forward rate calculation using the current price

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<sup>1</sup> Our comments will be focused primarily on Single Stock Futures (“SSF”) a subset of the broader universe of SFP. For the sake of clarity our use of SSF in this comment letter covers contracts on individual securities, ETFs and ADRs.

<sup>2</sup> In August of 2008, more than 10 years ago, OneChicago petitioned the SEC and the Commission to reduce SSF margin to 15% in order to be more in line with those afforded to derivatives in Portfolio Margin Accounts. That petition has yet to be acted upon.

of the underlying instrument and adjusting that price by risk-free rates of return out to the forward expiration.<sup>3</sup> Some derivatives adjust for dividend streams while others do not. Certain derivatives can be priced with basic math – multiplication, addition and subtraction - while others require an understanding of calculus as well as probability theory. Participants in the derivative space differentiate the various derivatives by a concept known as delta. Delta is a way to describe the rate of change of a derivative relative to the rate of change of the underlying instrument.

OneChicago lists for trading SSF contracts which have a delta of one which means that the instrument does not contain any optionality and it moves in sympathy with the underlying instrument point for point as would a perfect substitute. This perfect substitute is referred to as a Delta One derivative. There are only two types of Delta One derivatives: exchange traded SSF and over-the-counter (“OTC”) Total Return Swaps. In the over-the-counter world, they also refer to them with names such as Master Securities Lending Agreements (“MSLA”) and Master Securities Repurchase Agreements (“MSRP”). Whatever name they assign these perfect substitutes the fact remains they are all Delta One derivatives.

Delta One derivatives are primarily used in financing transactions where one party is perfectly hedged with zero exposure to the underlying market while facilitating market activity.<sup>4</sup> In such a transaction, a customer is looking to get synthetic exposure to a security at a lower cost. This is achieved by entering into a derivative transaction with a financing counterparty. Traditionally this transaction was done by large banks and broker-dealers at what is commonly known as a Delta One desk. In these transactions, the customer is seeking exposure to a notional amount of a security and the Delta One desk would enter into a swap derivative providing the customer with synthetic exposure. But the Delta One desk does not want exposure itself so prior to entering into the swap the Delta One desk borrows money from their treasury and interacts with the marketplace to accumulate an identical notional value in the underlying shares. The trade is pre-hedged. After the price of the hedge is established the Delta One desk prices the swap by adding an interest rate to the hedge price. This interest rate represents risk-free profit for the Delta One desk. The Delta One desk is long stock and short a Delta One derivative with zero exposure to subsequent moves in the security itself. They engage in near riskless transactions while facilitating the customer into a long or short synthetic risk position.<sup>5</sup> The same transaction can be done with SSF Delta One.

Other financing transactions occur in the over-the-counter markets where broker-dealers and banks look to borrow both cash (to facilitate the transaction described above) and securities for their customers who are looking to borrow securities for their market activities. In these types of transactions, the counterparty already has a risk position but would accept a perfect substitute for a short term if offered financial incentives. When looking to accumulate cash the parties transact in the equity repo space. In equity repo, the lender of the cash demands collateral which is satisfied by delivering securities that are widely available called general collateral. The process of transferring cash for securities has characteristics that make it appear to be a buy/sell transaction which can be interpreted as a disposition of the asset for cash subject to taxation if the asset had appreciated. Current tax law views disposition of assets as a taxable

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<sup>3</sup> Contract for Difference (“CFD”) is a derivative that is widely used outside of the United States that produces economic returns similar to SSF, Swap and certain Agreements but they do not have an expiration date and therefore forward value calculations are not needed.

<sup>4</sup> In practice, professional option market participants that take the other side of speculators immediately look to hedge the transaction in a correlated instrument but since the options do not have a delta of one the hedge must constantly be recalculated and additional trading must take place to keep the hedge intact.

<sup>5</sup> If done OTC the parties have Counter Party credit exposure. If done on an exchange and centrally cleared there is a non-zero risk that the clearing house itself implodes but this is extremely unlikely in our view.

event unless the transfer is done in a particular way. The transfer must be done pursuant “to an agreement” that calls for both the transfer and the return of the securities and during the term of the transfer all dividends and other capital distributions must be paid to the transferring party, and critically that during the term of the transfer the transferring party may not reduce the risk of loss nor opportunity for gain. What this means is that the lender cannot have a change in his/her risk profile with respect to the asset which is transferred. If this transaction was anything other than a riskless financing trade, a taxable event would have occurred.

The ‘agreement’ in the above transaction is called a Master Securities Repurchase Agreement which is just a fancy name for a Delta One derivative. Only a Delta One derivative can be used without triggering a tax event. This is critical to understand. No option or any combination of options can be used in these types of transactions as they are not Delta One. It is a perfect substitute. The same transaction can be done with SSF Delta One.

The banks and Broker Dealers also need to accumulate securities to cover fails in the clearing systems as well as to provide their customers who wish to borrow securities in order to sell them short in the marketplace. Again, the dealers seek out beneficial owners of the securities who agree to lend their shares in return for cash collateral and interest while simultaneously entering into a Master Securities Lending Agreement to avoid the transfer being viewed as a taxable event. The "agreement" is a derivative. A Delta one derivative.<sup>6</sup>

Whether financing a customer by placing them into a swap or by engaging in Securities Lending or Equity Repo the required derivative is a Delta One derivative. No other derivative works. No other derivative is equivalent.

Regulating derivatives that contain optionality similarly to those that do not is no different than imposing the same rules on chess and checkers because they are both played on a checkered board with 64 squares. It defies logic.

Regulating Delta One derivatives comparably, whether they trade OTC or on exchange, seems to be a smarter approach. Placing regulatory burdens on exchange traded Delta One derivatives that are not placed on OTC Delta One derivatives creates an uneven playing field picking winners and losers in the capital markets. Smart regulation fosters innovation and encourages transparency for the benefit of all participants in the capital markets. OneChicago disagrees with trying to level an imaginary playing field to achieve parity with a non-Delta One derivative. It does not make sense.

### **The Proposal**

“The Commission notes that SFP's and security options may serve economically equivalent or similar functions.” OneChicago fundamentally disagrees with this as no option nor any combination of options can replicate the transactions described above. Previous legislation and regulations which equated equity options and SSF were mistakes. The Commission makes a similar mistake when they claim in footnote 33. “Similarly, the price of a long put option with a strike price well above the prevailing market price of the underlying security is expected to move almost in lockstep with the price of a short SFP on the same

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<sup>6</sup> Securities Lending and Equity Repo are the same trade with different names. They both find safe harbor under IRC 1058 which speaks to these unique transfers.

underlying security." In theory, this is correct, but in practice deep in the money puts are exercised early by the long holder because by doing so they collect the proceeds from the sale of the stock which they then invest and at certain broker-dealers they get the benefit of the re-investment. SSF contracts do not work like this. Professional traders do not hold deep in the money put positions. Only smaller retail customers who aren't as sophisticated or perhaps do not get paid interest on those proceeds by their brokerage may be stuck in the option in practice deep in the money puts get exercised.

The OCC website confirms this. Interestingly, some deep in the money puts do have open interest. For these symbols, look at the deep in the money calls where there will be little open interest. These securities are hard to borrow and as a result holders of the calls will exercise their rights early so as to take delivery of the underlying security and immediately lend it out to capture the securities lending fee on the hard to borrow security. This exercise feature is not available using SSF.

The securities lending rebate fee mentioned above affects the forward pricing of all equity derivatives, whether or not they are Delta One. A derivative's fair value is calculated by determining the forward value of today's underlying price using risk free rates of return out to expiration and subtracting the present value of any dividends that will be paid between now and expiration.<sup>7</sup>

An easy way to understand this is if one were to invest \$100 in a savings account that paid 3% annually, there would be an expectation that at the end of the year there would be \$103 in the account ( $\$100 \times 1.03$ ). \$103 is thus the forward calculated value of the present-day value of 100 in the 3% risk free interest rate environment. While compound interest makes the calculation slightly more complicated, this is how you determine fair value for an SSF. Accordingly, for a \$100 stock in a 3% interest-rate environment, fair value for the six-month SSF should be roughly \$101.50 and the three-month future to be priced at \$100.75.

However, if the bank had a hidden fee of two dollars per year, at the end of the year there would be \$101 in the bank account instead of having \$103. That fee can be viewed as a negative interest rate and needs to be subtracted from the forward value or else pricing would not be accurate. A very similar process happens in the derivative space. A customer who correctly calculates a forward value of \$103 for a one year derivative in the example above would have arrived at the wrong value because they have not taken into account the securities lending fee.

The securities lending rebate rates are decided in the over-the-counter space and they have a direct observable effect on listed equity derivatives. The entities that determine the rebate rate do so in relative secrecy. Securities Lending rebate rates change and in the time frame between when the new rate is decided and when it becomes public there is a window of opportunity for those entities who determine the rate to front run the equity derivatives market. Customers on the wrong side of the variation in that rebate rate may have windfall losses that they cannot predict in advance nor understand afterward given that no other variable moved. This is a risk of trading options as well as SSF and we ask that the Commission and the SEC require the Risk Disclosure Documents for both options and SFPs to be updated to discuss this risk.

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<sup>7</sup> Dividend risk is only present for option trading. It is not needed for OneChicago's products as our dividend adjusted contracts allow customers to capture the value of the dividend and there is no risk that is comparable.

The Commission should take the potential for this type of manipulation into account when determining its regulations for listed derivative markets such as SSF. The tail does not wag the dog.

As we noted earlier, no matter how well intended, regulation that tilts a playing field between two identical (not just similar) derivatives is picking winners and losers and opens the door to potential manipulation of US equity derivative markets. Uneven playing fields encourages parties to participate in the non-transparent process and discourages participation in transparent processes. OneChicago believes that is not smart regulation and that the regulators should immediately move to allow for innovators to compete so the capital markets act more efficiently.

As the Commission is aware OCC now clears securities lending agreements in the same risk pools as OneChicago's contracts. Those Delta One derivatives have no position limits and they get risk-based margining. For Delta One products that clear at a SIFI with access to the Fed window for borrowing, OneChicago believes the OTC and exchange traded products should be treated the same. Yet as long as the Commission dogmatically insists on treating SSF like derivatives which are not Delta One, there will remain an un-level playing field.

### **Cash Versus Physical Settlement**

OneChicago believes that if a DCM list both cash and physically settled SSF on the same underlying that the combined positions for the same expiration date should be used in calculating position limits. Further while we agree on expanding the limits for physically settled contracts we believe that cash settled contracts pose a greater danger of potential manipulation on the closing price of the underlying security and should be constrained at the current position levels that are in force today. With physical settlement, if the long holder attempts to manipulate the underlying upwards to get additional variation payments, he would realize that he would be taking long stock via the expiration at an artificially high price which should correct the next day. The cash settled contract long holder does not take delivery of the artificial price but grabs the profits in the variation and so has a motivation to, individually or in concert with others, engage the underlying market to move it higher.

The experience of OneChicago has been, that exactly like Delta One transactions in OTC markets, one side of each transaction is perfectly hedged with long stock hedging a short SSF or a short stock (with a long borrow) hedging a long SSF. The parties that are extending the financing intend to take the position through expiration as the long stock would be used to satisfy the short SSF obligation and they would not have to do another transaction as the unwind would occur naturally through the guarantees of the clearing and settlement apparatus. The best way to extinguish a hedged position is to let it go through delivery.

We have attached as appendix A a table that summarizes on a monthly basis the percentage of SSF contracts that have gone through delivery since 2015.<sup>8</sup> Unlike traditional futures contracts where a very low percentage (perhaps 1% or less) go through delivery, there has been no month in the last four years that less than 53% of the open interest as of the first of the month go through delivery. We also note the Options Industry Council (OIC) recently put out statistics that show only 7% of options get exercised. That 7% number has held relatively constant for years. Participants exercise options for two reasons.

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<sup>8</sup> We looked at open interest on the first day of each month in the contracts that would expire on the third Friday and calculated what percentage went through the delivery process.

First, calls are exercised to harvest dividends. Second, as described earlier, deep in the money puts are exercised to invest the proceeds from selling the stock.

The table clearly shows that one of the characteristics of SSF that market participants find most useful is the ability to transfer securities through the OCC and NSCC guaranteed processes. Why does the Commission seek to treat SSF the same as options when the market clearly views them so differently?

### **Position Limits in Effect on Expiration Day**

OneChicago does not believe that position limits should be in effect for the five days prior to expiration but that they should only be in effect on expiration day. The Commission originally decided upon five days because of their experience in other futures markets and because of the exercise restrictions in equity options. OneChicago does not believe this has a meaningful application to SSF. As we have noted, our experience has been that one side of the trade is always hedged and prepared to go through delivery. There is no interaction with the underlying market in order to get the inventory needed to meet the SSF obligation. It is pre-hedged. For the speculator on the long side who has not rolled their position forward they simply need monies in their account at their brokerage firm. The controls on brokerage account operations is clearly in the domain of the broker-dealer. All FCM customers roll their positions forward or extinguish the positions prior to expiration as taking delivery of securities, while theoretically possible, is not practical and the FCM make the process uneconomical for the customers.

### **STARS Exemption**

OneChicago offers for trading a particular spread transaction with a unique settlement feature specifically designed to facilitate the transfer and return of securities. We market them as STARS (Securities Transfer And Return Spreads). The front leg in this integrated transaction is a weekly contract that will expire that day and the back leg of the transaction is a distant expiration. Since the front leg will expire that afternoon, the only compelling feature of the front leg is the characteristic that going through expiration will trigger the transfer of securities for cash on T+1. It is very similar to an EFP but the two parties transfer the underlying securities via the SSF rather than crossing the stock themselves.

STARS trades are pure financing trades allowing two parties to transact where Party A transfers securities and replaces them with a Delta One substitute while maintaining the exact risk profile as the underlying position. Party B is simply financing the transfer by accepting delivery of the securities in return for cash while maintaining a hedged Delta One position with the short SSF, guaranteeing that the trade will unwind at the distant expiration.

These transactions only occur on expiration day of the front leg which would require participants to seek exemptions and we see no value in this. Further, our rules allow customers to 'look back' and request an exemption for a position that was established the day before. For STARS transactions, this would mean both parties would need to request an exemption for a position that no longer exist as it has gone through delivery. Since this amounts to unnecessary paperwork, we request that DCMs should have the authority to exempt STARS transactions from position limits entirely.

## **Authorize Position Accountability for all ETFs**

Instead of treating SSF on ETFs like other SFF on common stock, OneChicago believes that Commission could improve its proposal by authorizing position accountability for all ETF SSF. As the Commission notes, authorized participants may increase or decrease the number of outstanding shares to keep the price of the ETF in line with the value of the underlying assets. This dynamic makes both estimated deliverable supply and trading volume unsuitable for assessing an ETF's liquidity as both can change rapidly and neither reflect the ability for market participants to buy and sell the product. In addition, authorized participants make both market disruption and manipulation far less likely in ETF products. If a market participant needs to deliver shares, their bids will push the price of the ETF upward and in turn prompt authorized participants to create shares to keep the price of the ETF in line with the value of its underlying components. Similarly, if a market participant attempted to manipulate or corner the market in an ETF, their efforts would be counteracted by the share creation and redemption process.

OneChicago believes that a position accountability level of 25,000 contracts provides sufficient protection for all ETF SSF. This level ensures that any market participant with a position above the accountability level would be examined by the exchange. OneChicago recognizes that even with share creation by authorized traders, some ETFs have low liquidity. If the Commission is still uncomfortable with position accountability of 25,000 contracts for low liquidity ETFs, they could authorize position accountability at a lower level than 25,000 for low liquidity products. This would provide better protection against an unwanted market impact than setting the limit at the default position limit level. Even under Position Accountability, a DCM would be unlikely to allow a market participant to hold a naked position exceeding 25,000 contracts for an illiquid ETF unless the DCM was convinced that the participant had the ability to deliver upon maturity and was not attempting market manipulation. This would provide similar protection to the exemption process under a default position limit. However, with the lower accountability level, the DCM would examine a market participant's position at a lower level than under a default position limit. For example, if the lower accountability level were set at 15,000 contracts, position in between 15,000 and 25,000 would be examined under position accountability but not under the default limit. The lower accountability level should be set by examining the estimated deliverable supply of the ETF components. As ETF liquidity can only be accurately judged by the liquidity of its underlying components, OneChicago does not recommend setting this threshold based on the estimated deliverable supply or total trading volume of the ETF itself.

By allowing for position accountability in ETF SSF products, the Commission would give DCMs greater discretion to regulate products in which liquidity cannot be accurately judged by traditional measures and there is a very low likelihood of manipulation.

## **Response to Commission Questions**

OneChicago would like to take the opportunity to briefly respond to some of the issues raised in the Commission's proposal.

### *Default Position Limit of 25,000 contracts*

While OneChicago believes that increasing the default position limit to 25,000 is an improvement over the status quo, it does not level the playing field between SSF and OTC Delta One products.

### *12.5% of Estimated Deliverable Supply*

OneChicago recommends increasing the percentage for higher position limits to 25% of estimated deliverable supply in accordance with other futures products. Other than the misconception that SFF and security options compete, there is no justification for a lower level. There are at least two justifications for a higher level. First, reducing the regulatory disparity between OTC and SSF markets. Second, SSF are almost exclusively used for riskless financing and transfer transactions.

### *Alternate Criteria for Position Limits*

OneChicago opposes the Commission's alternate criteria which would allow DCMs to set position limits for SFP at the equivalent level as equity options. The Commission should not perpetuate the myth that the two products are equivalent. OneChicago agrees with the Commission that it is appropriate to use a linear approach of position limits where a doubling of estimated deliverable supply results in a doubling of the position limit.

### *Gross Position Limits*

OneChicago does not support using gross position limits for SSF. Unlike options which have variable strike prices, a customer cannot hold both a long and short SSF with the same symbol and expiration, making the application of gross position limits meaningless. This provision merely serves to perpetuate the myth that options and security futures are competing products.

### *Semiannual Rebalance*

OneChicago supports the Commission's proposal to allow DCMs to recalculate position limits on a semiannual basis instead of a monthly basis. In OneChicago's experience, rebalancing monthly provides very little value.

### *Estimated Deliverable Supply*

Estimated deliverable supply as the Commission has calculated it does not accurately reflect the availability of deliverable shares. In equity markets, market participants going through settlement do not have to purchase shares, they more often than not simply borrow them. The only way to ascertain deliverable supply then is to find out how much of the float is available for lending. Those are closely guarded secrets by the participants in the Securities Lending world. To be honest we really are not concerned by this issue as Broker-Dealers understand this market, are well positioned to determine supply, and will not allow themselves to be put into a position where they cannot deliver. The Commission should rely on that market for its determination of estimated deliverable supply.

### *Liquidity Assessments*

OneChicago supports the Commission's proposal to give DCMs the discretion to determine if the liquidity in a product justifies setting the position limit lower than the default level. DCMs are inherently more flexible and agile than the Commission, allowing DCMs to adjust to changing market conditions more quickly. OneChicago is also concerned that the Commission may not accurately reflect liquidity since it does not take account of borrowable shares.



## *Regulating Unlisted SFPs*

OneChicago believes that the general framework that the Commission has already provided is sufficient to give innovators a clear view of regulations in the SSF marketplace. OneChicago does not suggest that the Commission promulgate regulations for unlisted SSF unless there is interest in listing such products. Acting otherwise would risk stifling innovation. However, OneChicago believes that the more important issue is having a regulatory scheme which can quickly adapt to market developments. Unfortunately, the Commission has not followed this principle in regulating SSF markets. Default position limits for security options were raised to 25,000 contracts in 2008. By the Commission's flawed logic that SSF and security options are identical, position limits for SSF should have been increased shortly afterwards. Position limits are not the only area where the Commission has been unresponsive to SSF markets. OneChicago has had a petition for joint rulemaking for margin relief pending with the Commission for over 10 years. If the Commission is really concerned about its regulations stifling innovation in SSF, it should not wait a decade to respond to reasonable DCM petitions.

## **Conclusion**

The Commission's proposal reaffirms the regulatory disparities faced by SSF. Instead of creating a framework designed to allow SSF to compete with their OTC and overseas competition, the Commission insists on reinforcing the flawed assumption that SSF and security options are economically equivalent. Although the Commission's proposal replaces a framework obsolete for more than a decade, it replaces it with one based on the same obsolete principals.

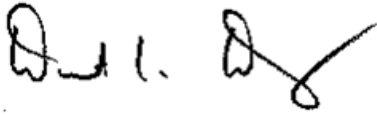
Instead of attempting to apply another market's position limit scheme to SSF the Commission should implement smart regulations specifically tailored to account for the unique circumstances of the SSF market and to achieve regulatory parity with the OTC products. The proposal is an improvement but does not remove the regulatory shackles from SSF. We would love the opportunity to applaud in a more robust manner, but our hands are tied tightly behind our back.

One final thought. Despite being played on the same board it is impossible to play chess with checkers. Similarly, you can't use options in financing transactions. **Placing burdens such as unreasonable margins or meaningless position limits upon SSF serves only one purpose and that is to protect the OTC market from competition by innovators in the regulated exchange space.**

Either the Commission does not understand this reality, or they choose to ignore it. For the sake of the capital markets we pray it is the former.

OneChicago sincerely appreciates the opportunity to comment on the proposal and would like to make itself available to provide further input to the Commission regarding the proposal. OneChicago looks forward to working with the Commission to address the issues described above. If you have any questions or comments regarding this submission, please feel free to contact me at any time by phone at (312) 883-3440 or through email at [ddowney@onechicago.com](mailto:ddowney@onechicago.com)

Sincerely,

A handwritten signature in black ink, appearing to read "D. G. Downey". The signature is written in a cursive style with a large initial "D" and a long, sweeping tail.

David G Downey  
Chairman and CEO

## Appendix A: Delivery Statistics

### Percentage of OneChicago SSF Delivered Each Month\*

<b>Month</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>January</b>	83.21%	73.24%	80.33%	80.68%
<b>February</b>	102.80%	73.29%	74.47%	64.14%
<b>March</b>	87.86%	94.83%	85.13%	80.10%
<b>April</b>	81.93%	70.28%	67.79%	87.51%
<b>May</b>	110.15%	90.02%	61.07%	68.52%
<b>June</b>	81.81%	75.12%	50.91%	62.53%
<b>July</b>	64.55%	71.09%	66.30%	58.11%
<b>August</b>	66.56%	84.23%	59.94%	53.10%
<b>September</b>	83.77%	66.12%	62.41%	56.10%
<b>October</b>	86.00%	71.21%	73.49%	-
<b>November</b>	75.07%	80.67%	86.77%	-
<b>December</b>	65.77%	147.64%	76.21%	-
<b>Total</b>	82.46%	83.14%	70.40%	67.87%

\*Delivery percentage is calculated by taking the ratio of open interest in the expiring month's contracts on the first of the month to the number of contracts delivered that month.