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Mr. Michael Macchiaroli
Division of Market Regulation
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Response to comments received on SR-NYSE-2006-13
regarding Portfolio Margining Requirements

Dear Mr. Macchiaroli:

On March 2, 2006, the New York Stock Exchange (the "Exchange" or "NYSE") pursuant to Rule 19b-4[1] under the Securities Exchange Act of 1934[2], submitted to the Securities and Exchange Commission (the "SEC" or "Commission") File No. SR-NYSE-2006-13 (the "Filing"), which proposed amendments to NYSE Rule 431 ("Margin Requirements") that would expand the scope of products that are eligible for treatment as part of the SEC approved Portfolio Margin Pilot Program. The proposed amendments expand the current portfolio margining pilot program to include additional types of securities allowed in a portfolio margin account, specifically, all margin securities (as defined in section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System, excluding nonequity securities), listed options, unlisted derivatives and security futures products. The Exchange also proposed to increase the number of eligible participants by eliminating the five million dollar minimum equity requirement, except for those participants that wish to maintain positions in unlisted derivatives and the elimination of the cross-margin account. Amendments to Rule 726 ("Delivery of Options Disclosure Document and Prospectus") were also proposed to include the SEC approved products on the disclosure document required to be furnished to customers pursuant to this rule.

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1 17 CFR 240.19b-4.

2 15 U.S.C. 78a et seq.

The Filing was noticed for comment in the Federal Register on April 6, 2006.[3] The comment period, which was set to expire on April 27, 2006 but was extended until May 7, 2006, resulted in five comment letters received from the Options Clearing Corp. ("OCC"), Securities Industry Association ("SIA"), the Chicago Mercantile Exchange ("CME"), Dechert LLP (on behalf of Federated Investors) and FiMAT USA (collectively the "Commenters").

The Exchange welcomes the comments and the opportunity to respond to them. All of the comments were generally in favor of the proposal. The Exchange encourages the Commission to adopt these amendments.

Several comments were submitted regarding the ability to use risk-based models other than the OCC's TIMS model to calculate the risk associated with portfolio margin accounts. One commenter stated that the Commission has experience in approving proprietary models for consolidated supervised entities and broker-dealers subject to the SEC's rules for OTC derivatives dealers. The Exchange acknowledges that proprietary risk models may prove to be effective and efficient in managing risk but believes that initially, the regulators should gain experience with the TIMS model that has already been approved by the SEC. Longer-term, proprietary risk models could be considered as alternatives to TIMS.

Comments were submitted that focused on the cross-margining aspect of portfolio margin, specifically, cross-margining at the clearing organization level. Two approaches were discussed, the "one-pot" approach and the "two-pot" approach. The "one-pot" approach refers to the use of one account for both security and futures positions, within a single regulatory, capital and customer protection framework. The "two-pot" approach refers to the use of two accounts for securities and futures, whereby each clearing organization guarantees a member's obligations to another clearing organization with respect to any collateral requirement. While one commenter pointed out that the "two-pot" approach was approved by the CFTC and SEC in 2001 to permit hedging between positions in government securities with interest rate futures and futures on government securities, the approval is limited to proprietary positions of members and that no "two-pot" approach has ever been developed for customer accounts. One commenter favors the "two-pot" approach because it more easily accommodates differences in customer protection and capital requirement structures between the SEC and the CFTC.

One commenter expressed the need for the SEC and the CFTC to continue working to eliminate the legal and regulatory impediments to cross-margining, and more specifically, for the CFTC to use its authority under the Commodities Exchange Act ("CEA") to

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[3] See Release No. 34 –53577 (March 30, 2006) 71 FR 17539 (April 6, 2006) (SR-NYSE-2006-13).

exempt futures and options on futures from the segregation requirements of the CEA. Another commenter discussed the concern the CFTC may have in relinquishing its regulatory authority by permitting products to be carried in a securities account. The commenter believes that, in order to avoid any concern, having the CFTC impose conditions on the use of futures products in a securities account can narrow any relief given with respect to segregation requirements. The Exchange believes that a one pot approach will provide for more efficient margining, reduce broker-dealer/FCM liquidity risk as well as reduce operational inefficiencies. Further, the Exchange believes that the legal and regulatory impediments to cross-margining can be overcome and will continue to work with the SEC and CFTC so that the industry can move forward with the "one-pot" approach to cross-margin.

Several comments were submitted regarding the types of products eligible for portfolio margin. One commenter stated that in order for portfolio margin to be fully implemented, nonequity securities should be included. Further, if nonequity securities cannot qualify as eligible products for portfolio margin, then they should at least be used as collateral in a portfolio margin account, subject to the current provisions of Rule 431. The Exchange agrees and therefore will permit the use of nonequity security positions in a portfolio margin account only to the extent they are used for collateral purposes. Member organizations must have the ability to apply the applicable strategy based margin requirements promulgated under this Rule. After the SROs and broker-dealers have gained more experience with portfolio margining, the application of risk-based margin requirements to nonequity securities could be considered.

One commenter sought clarification whether broker-dealers and their customers could use shares in money market funds as collateral for portfolio margining. The Exchange believes the Rule currently permits the use of money market funds in a portfolio margin account by allowing the use of all margin equity securities. The definition includes "any security issued by either an open-end investment company or unit investment trust which is registered under section 8 of the Investment Company Act of 1940...". This definition includes money market mutual funds.

The SIA objected to the $.375 minimum margin per contract. Two possible alternatives were suggested: 1) apply a "volatility shocking" by stressing each portfolio by 20% and reducing the minimum requirement to $.125 per contract, or, 2) retain the $.375 minimum requirement for those accounts that do not maintain five million dollars in equity, and $.125 for those accounts that do maintain the five million dollars in equity. The Exchange believes that the $.375 minimum requirement per contract provides a cushion against significant market movements. The Exchange is concerned about potential illiquidity in the market and the creation of gap risk in the event both sides of a hedge cannot be closed out simultaneously.

The prohibition of day trading in a portfolio margin account was raised in several comment letters. One commenter stated that since firms will be required to monitor risk on an intra-day basis, there is no need for this prohibition. Another commenter stated that the prohibition is contrary to the spirit and intent of the movement toward portfolio margining, which is to establish risk-based margining systems rather than margin systems based on specific trading strategies or products. The intention of the proposed rule was to provide a more realistic, risk-based approach to maintenance margin and to prohibit the practice of day trading in a portfolio margin account. The Exchange acknowledges that there may be situations whereby a customer opens a position at the beginning of a trading day and, due to market conditions, closes out that position later in the day. The rule is not intended to prohibit intra-day trading in an account that contains a large portfolio of hedged instruments. It is intended to prohibit pattern day traders from benefiting from incremental gains. The Exchange will clarify its intent by amending the rule text.[4]

One commenter is interpreting the references to limits on the extension of credit, as outlined in section (g)(1), to mean that firms should not be required to impose limitations on portfolio margin accounts, but rather it be interpreted to mean that firms should evaluate each customer to determine the overall risk exposure that is appropriate for that customer. The Exchange reiterates its intent of the rule to mean member organizations are not required to impose specific credit limits as a matter of policy, but rather determine the credit profile of each customer, and if the member organization believes that it is necessary to impose a credit limit, to ensure that the procedures promulgated in section (g)(1) are adhered to.

One commenter highlighted an inconsistency in the rule text regarding unlisted derivatives. Section (g)(4)(C) states that any person or entity that is not a registered broker-dealer or a member of a national futures exchange, and does not establish and maintain a minimum equity of five million dollars, cannot establish or maintain a position in an unlisted derivative. However, section (g)(6)(B)(2) states that if such a participant does not establish or maintain a minimum equity of five million dollars, then any long or short position in an unlisted derivative that is not part of a hedge strategy must be transferred to the appropriate securities account within ten business days. This has

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[4] The text in section (g)(13) which currently reads "[d]ay trading is not permitted in portfolio margin accounts" will be struck out. Section (g)(13) will be amended to read: "The use of a portfolio margin account for purposefully engaging in a strategy of "day trading," as defined in section (f)(8)(B) of this Rule, is prohibited. However, day trading will not be deemed to have occurred in a portfolio margin account whenever the position or positions day traded were part of a hedge strategy that reduced the risk of the portfolio. Member organizations are expected to monitor portfolio margin accounts to detect and prevent circumvention of the day trading requirements. "

created a contradiction in the rule text. The Exchange's intent is to prohibit those participants that do not establish or maintain minimum equity of five million dollars, except for a registered broker-dealer or member of a national futures exchange, from maintaining a position in an unlisted derivative, whether it is part of a hedge strategy or not. The commenter suggested that this section of the proposed rule be deleted. The Exchange agrees and will delete the text.

The commenter also suggested revising the definition of eligible participants in section (g)(4)(C) to exempt specific transactions from the five million dollar equity requirement if the risk is so limited to make the requirement unnecessary. The Exchange does not agree with the approach of determining risk on a case-by-case basis to determine if a customer is required to establish and maintain equity of five million dollars, because of the additional leverage that can be created.

Several other less significant comments were submitted regarding the actual rule text that will be considered in the revisions being made to the rule as a result of the overall comment process.

This letter will be followed by amendments to our rule. We encourage the SEC to move forward in approving the amendments.

Questions concerning this letter may be directed to Grace B. Vogel, Executive Vice President - Member Firm Regulation, at 212-656-2947 or Albert Lucks, Managing Director – Credit Regulation, at 212 -656-5782.

Sincerely,

Mary Yeager
Assistant Secretary