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May 16, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-9303

Re: File Number SR-NYSE-2006-3, 71 Fed.Reg. 17539 (April 6, 2006) and
File Number SR-CBOE-2006-14, 71 Fed.Reg. 17519 (April 6, 2006)

Dear Ms. Morris:

On behalf of the *Ad Hoc* Portfolio Margining Committee, the Derivatives Product Committee and the Options Committee ("the Committees") of the Securities Industry Association ("SIA"),[1] we are pleased to offer you our comments on the above referenced proposals by the New York Stock Exchange ("NYSE") and the Chicago Board Options Exchange ("CBOE") (collectively, the "Exchanges") that would amend the Portfolio Margin Pilot Program ("the Pilot Program") in NYSE Rule 431(g) and CBOE Rule 12.4. We view both filings as important and substantial further steps toward a comprehensive portfolio margin program. We commend the Exchanges on their proposals and urge the Commission to approve these rule changes, subject to certain suggestions set forth in this letter that we believe would strengthen the rules as proposed.

We strongly support the significant step forward represented by the currently proposed changes, and also want to take the opportunity to reaffirm what should be the ultimate goal of portfolio margining: to enable firms to permit qualified customers to maintain a single account in which virtually any financial product can be carried, and in which credit can be extended, subject to margin requirements that are determined on the basis of an SEC- or Exchange-approved, risk-based methodology. Ideally, such a methodology would be developed by each firm, subject to model control policies that are reviewed by appropriate regulatory authorities. We believe that it is essential to the competitive position of U.S. financial intermediaries in the global market to be able to provide this same service that is currently being provided by financial institutions outside the United States. We also believe that it is in the

[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

interest of protecting the U.S. and global financial systems against systemic risk to facilitate the integrated management of risk across a diverse portfolio of products subject to different regulatory regimes.

The Commission now has experience in approving model control policies for consolidated supervised entities as well as broker-dealers subject to the Commission's rules for OTC derivatives dealers. The model control policies developed in these contexts should be equally applicable to models for portfolio margining. In this way, models developed for portfolio margining purposes by firms subject to these rule sets would not be subject to a separate sign-off by regulators, but would be subject to such firms' model control policies that have been previously approved by a regulator.

The present rule filings are a step in the right direction. However, even after certain legal and regulatory obstacles identified below are addressed so as to permit the expanded Pilot Program to be fully implemented, there is still a distance to go in achieving the full potential of portfolio margining. For example, portfolio margining accounts should include as eligible products nonequity securities, interest rate derivatives, collateralized debt obligations ("CDOs") and other similar nonequity-related products as well as foreign currency derivatives.

<u>Overview of the Proposals</u>

Both the NYSE and the CBOE proposals will further expand the scope of financial instruments eligible for "portfolio margining" to include over-the-counter ("OTC") equity- and index-based derivative instruments and individual securities underlying OTC and exchange-traded derivative instruments or included in an index underlying any such derivative instruments. Both proposals would expand the classes of investors eligible to open a portfolio margining account, and would eliminate certain other restrictions that limit the usefulness of the existing Pilot Program. In addition, both proposals would provide more detailed requirements regarding the risk management procedures that firms carrying portfolio margin accounts must have in place and would give the Commission and the Exchanges greater oversight authority with respect to those procedures.[2]

While the two filings are generally very similar to each other, there are a few very significant differences between them. Consistent with the general practice of maintaining substantively similar margin rules among all national securities exchanges, we urge NYSE and CBOE to conform their rule proposals in substance. In this regard, we much prefer the NYSE's proposal to use a single account for both "portfolio margining" and "cross-margining" transactions. We also note that the CBOE proposal would require that positions in underlying securities, long options and warrants must be hedged in order to be held in the portfolio margining account whereas the NYSE proposal contains no such restriction. We urge CBOE to conform its filing to the NYSE proposal in that regard. In certain other respects identified in our comments below, we prefer the CBOE's version of the rule. We also suggest that the

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[2] The original portfolio and cross-margin pilot programs were limited to exchange-traded, broad-based index products. *See* Release No. 34-52031 (July 14, 2005), 70 FR 42130 (July 21, 2005); (File No. SR-NYSE-2002-19). The Exchanges subsequently proposed amendments to the pilot to include security futures and listed options on single stocks. *See, e.g.*, SR-NYSE-2005-93, 71 Fed. Reg. 3586 (January 23, 2006).

Exchanges eliminate differences in terminology for the principal concepts: *e.g.*, “OTC derivative” (NYSE) vs. “unlisted derivative” (CBOE). In addition, the required disclosure statements and customer acknowledgements in the two rules should be carefully reviewed to conform them to each other and to the portfolio margining rules as they are proposed to be amended.

Remaining Barriers to Implementation of the Pilot

It is important for the Commission to recognize that, although the proposals of the Exchanges both include provisions for the inclusion of certain commodity futures products (referred to in the filings as “related instruments”), these provisions cannot be implemented without further action by both the SEC and the CFTC to remove legal and regulatory barriers to “cross-margining” of securities products with futures products (other than security futures products, which can be carried in either futures or securities accounts and therefore present no problem). To achieve this:

- We urge the SEC staff to coordinate with the CFTC staff and urge the CFTC to use its statutory authority under the CEA to exempt futures and futures options from the segregation requirements of the CEA to the extent necessary to permit them to be carried in portfolio margin accounts, which are regulated as securities accounts, and to be liquidated under the provisions of SIPA in the event of the insolvency of the carrying broker-dealer/FCM.

- We urge the SEC staff to proceed promptly with a proposal that we understand has been prepared by the staff of the Division of Market Regulation that would make use of certain authority conferred upon the Commission under the Securities Investor Protection Act of 1970 (“SIPA”) to ensure that, in the event of the insolvency of the carrying broker-dealer/futures commission merchant, proceeds of futures and futures options carried in a portfolio margining account would be included in the pool of “customer property” and that cross-margining customers would have claims as customers rather than being reduced to the status of general unsecured creditors to the extent that they have claims for the proceeds of futures and futures options (other than security futures products, which are clearly “securities” for purposes of SIPA). This issue might also be addressed by a narrowly crafted amendment to SIPA itself. In the absence of taking either action, the risk disclosure document should be reviewed to be certain that any limitations on the applicability of SIPA are appropriately disclosed.

As proposed, the portfolio margin account would include certain OTC derivatives (such as equity swaps and equity index swaps) that are excluded by Section 301 of the Commodity Futures Modernization Act of 2000 from the definition of a security in Section 3(a)(10) of the Securities Exchange Act of 1934, as amended. Inclusion of OTC derivatives that are not themselves securities could raise a question as to the appropriate treatment under SIPA of customer claims arising from those contracts in the event of the insolvency of the carrying firm. We suggest that this issue be addressed as an initial matter through appropriate disclosure.

Minimum Margin Requirements

We object to the fixed contract minimum margin amount that is presently included in the proposals of both Exchanges. We believe that such a fixed minimum is a crude and arbitrary approach to establishing prudential margins, and is inconsistent with a true risk-based approach. The inclusion of this provision could significantly undermine the usefulness of the portfolio margin account for significant groups of clients. The following paragraphs analyze the issues as we see them and propose two alternative approaches.

The margin required in a portfolio margin account is based essentially on the methodology employed in Appendix A of the Net Capital Rule. Of course, the Net Capital Rule is not a margin rule. It is intended to establish capital requirements for firms that finance the positions of options market-makers, since these accounts are not "customers" for purposes of Rule 15c3-3, and are entitled to "good faith" margin under Regulation T and Rule 431. The practical result of this regulatory structure is to allow firms carrying the accounts of option market makers to provide portfolio margining (and cross-margining with index futures) to options market makers.

It is instructive to understand how firms providing credit to options market makers actually manage their business to avoid credit losses. In practice, carrying firms do not use Appendix A as their exclusive method for determining how much credit to extend to market-maker accounts. Carrying firms have adopted proprietary risk models that they believe best capture a market-maker's trading risk on a real time basis. Any given market-maker is allowed to trade in proportion to the amount of equity in the market-maker's account subject to the application of the carrying firm's risk model. The carrying firms also measure the market-maker's positions against the requirements of Appendix A, and to the extent that the market-maker's positions exceed the Appendix A computation, the firm takes the required capital charge equal to the deficiency.

As we examine the proposed rules against market practice, we note that while carrying firms routinely require a minimum equity, the proposed CBOE and NYSE rules do not require any minimum equity. The minimum margin requirement is the minimum equity. Perhaps for this reason, the proposed rules may have the effect of increasing the minimum margin required in a portfolio margin account from requirements set forth in Appendix A of the Net Capital Rule.

The minimum margin required in paragraph (g)(7) is based on the greater of two factors. The first is to determine the largest theoretical loss in a position at 10 equidistant valuation points pursuant to the portfolio grouping criteria set forth in paragraph (g)(8)(A) and applying the percentages and models set forth in paragraph (g)(2)(I), then applying the any applicable offsets specified in paragraph (g)(8)(C) and summing the greatest loss for each portfolio pursuant to paragraph (g)(8)(D). The second factor is to apply an arbitrary value of $.375 to each of the various enumerated derivative contracts, multiplied by the contract's multiplier. (For example, for a listed equity option contract, the value would be $37.50.) While the first factor generally applies the methodology contained in Appendix A of the Net Capital Rule, the second factor increases the value in Appendix A ($.25 per contract) by fifty percent.

We believe that, for many portfolio strategies pursued by the most likely institutional users of portfolio margining, the application of the second factor may result in margin requirements that exceed the actual risk in the portfolios as well as the requirement computed under the methodology within Appendix A of the Net Capital Rule. This is a disincentive to those users to repatriate their positions currently margined offshore. We believe that it is appropriate from a prudential standpoint that member firms be permitted to extend credit to customers—at least those customers maintaining $5 million in equity—on a basis that more closely resembles the methodology employed by market maker carrying firms.

As noted above, we believe that the current methodology set forth in Appendix A, and on which the proposed rules are based, fails to reflect risk management models used effectively by risk managers in the process of determining the size of positions that can be supported by a given amount of account equity. In particular, the theoretical pricing model does not, but should, stress the derivative portfolios' implied volatility. We understand that the OCC is capable of supplying data that would allow firms to apply "volatility shocking" as an additional market risk measure by stressing each portfolio by an implied volatility factor of 20% down and 20% up. Using this factor as an additional "greatest loss" measure in addition to the first factor should allow for a more precise determination of potential loss, thus reducing the need for the application of the second factor at the proposed $.375 level. We believe the per-contract factor could be reduced to $.125 per contract.

We urge that the CBOE and NYSE proposed rules be amended in one of two ways.

- <u>First alternative:</u> add the "volatility shocking" measure as a second means of measuring the "greatest potential loss" in a given portfolio. The "greatest loss" for purposes of each portfolio in paragraph (g)(8)(B) would be the greater of the gains or losses computed by reference to paragraph (g)(2)(I) or the "volatility shocking" test. It should therefore be prudent to reduce the "per contract" alternative measure to $.125 per contract.

- <u>Second alternative:</u> retain the methodology in the proposed rule for accounts that do not maintain $5 million in equity, but amend the proposed rules to provide that the minimum margin applicable to customers maintaining $5 million in equity (whether or not required to do so) would be the amount determined by applying the $.125 per contract minimum consistent with the first alternative above.

<u>Additional Comments on NYSE Filing</u>

For the convenience of the Commission and the Exchanges, we have attached as an Appendix to this letter some specific drafting suggestions in the form of a mark-up of proposed NYSE Rule 431(g). Where necessary or appropriate, we have included brief comments in the Appendix explaining the reasons for the suggested changes. The following are some additional or supplemental comments of a more general nature relating to the NYSE filing.

- We have suggested deleting Rule 431(g)(6)(B)(2) as presently drafted. It states that customers (other than broker-dealers and certain futures exchange members) not meeting the $5 million equity requirement must transfer positions in OTC derivatives if they are no longer part of a hedging strategy unless the positions again become part of a hedging strategy. However, under paragraph (g)(4)(C) of the Rule, customers not meeting the $5 million minimum equity requirement are not permitted to have OTC derivative positions in the first place. Paragraph (g)(6)(B)(2) as currently in effect states that any position in any eligible product must be transferred if not part of a hedging strategy. We applaud the elimination of this requirement. However, the remaining provision is unclear. If it is intended to address situations where a customer subject to the $5 million equity requirement ceases to meet it, we believe that it is covered by paragraph (g)(9) of the rule. We suggest that, for the sake of clarity, all provisions having to do with the consequences of ceasing to meet the minimum equity requirement should be incorporated into paragraph (g)(9) of the Rule.

- Proposed Rule 431(g)(13) adds a prohibition against day trading in portfolio margining accounts and obligates members to monitor accounts to detect and prevent day trading. We suggest deleting this requirement. Such a prohibition is both unnecessary and inconsistent with the broad purposes for which portfolio margin accounts are established. The types of customers that are expected to use portfolio margin accounts will include active traders who may pursue strategies that require them to trade in and out of positions frequently during a trading day. Market-makers/specialists have always engaged in such trading, and firms that clear market-maker/specialist accounts manage the risk by having systems that monitor risk on an intra-day basis. Rule 431(g)(1)(C) as proposed already requires member organizations to have approved procedures for monitoring credit risk in portfolio margin accounts on both an intra-day and end of day basis. These procedures should be sufficiently robust to allow firms to manage the risk of day trading. We note that the CBOE rule filing contains no prohibition against such trading, and we urge the NYSE to conform its filing in that regard by eliminating the prohibition.

- We understand that the Commission staff and the Exchanges have determined to restrict the portfolio margin pilot to equity-based products and indexes. While we do not object to the exclusion of nonequity products from the risk-based margin calculation for purposes of the initial pilot, we believe that nonequity securities (including money market funds) should be includable in a portfolio margin account solely for collateral purposes, to be valued for collateral purposes as provided in other provisions of Rule 431.

- We note that the NYSE's proposed procedures for approval and monitoring of portfolio margining accounts include references to limits on credit extensions. *See, e.g.,* Rule 431(g)(1)(A), (B) and (G). We do not believe that these references should be interpreted to require firms to establish a specific dollar amount as a limit on the amount of credit that can be extended (*i.e.*, the debit balance) to a particular customer. We believe the requirement should be interpreted to mean that a firm should evaluate each customer to determine the overall risk exposure that it is appropriate for the firm to have to that customer.

Additional Comments on CBOE Filing

Some, but not all, of the comments on NYSE Rule 431(g) as reflected in the Appendix to this letter are applicable to corresponding proposals in the CBOE rule filing as well. The following additional comments relate specifically to the CBOE filing.

- CBOE Rule 12.4, in the third paragraph, requires that cross-margin positions be confined to a portfolio margin account dedicated exclusively to cross-margining. We believe that this requirement is unnecessary and inconsistent with a fully risk-based approach. We strongly urge CBOE to drop this requirement as the NYSE has done in its rule filing.

- Rule 12.4(d)(3) and (4) require that positions in underlying instruments be removed from the portfolio or cross-margining account if they are not part of a hedge position and also require the removal from the account of fully-paid long options and index warrants if they are the only positions in the account. The NYSE no longer proposes to have such requirements and, as noted above, we believe that they should be eliminated from the CBOE proposal as well.

- CBOE Rule 12.4(e)(2) imposes a two-tiered minimum margin requirement. Our comments above on the NYSE minimum margin proposal are equally applicable to the CBOE proposal, and we would suggest the same alternatives to the CBOE.

* * *

The Committees appreciate the opportunity to submit these comments on the NYSE and CBOE proposals. We wish to reiterate our strong support for the proposals and our wish that the Commission and other regulators will continue their efforts to expand the categories of products eligible for portfolio margining. In addition, if implementation issues arise once the rule proposals have been approved, SIA stands ready to organize volunteers from our member firms to assist the exchanges. If you have any questions concerning our letter or wish to discuss the subject matter, please do not hesitate to contact Jerry Quinn, Vice President and Associate General Counsel of the SIA, by telephone at (212) 618-0507.

Sincerely,

/s/ James Barry
James Barry
On Behalf of the *Ad Hoc*
Portfolio Margining Committee

/s/ John Vitha
John Vitha
Chair
Derivatives Product Committee

/s/ Christopher Nagy
Christopher Nagy
Chair
Options Committee

Appendix to SIA Comment Letter Dated May 16, 2006
SIA Comments on Text of
Portfolio Margin Rules as Proposed in
SR-NYSE-2006-13

The text of NYSE Rule 431(g) as proposed to be amended in SR-NYSE-2006-13 is set forth below. Additions as proposed by NYSE in the filing are underlined. NYSE's proposed deletions are in brackets. SIA's proposed further additions are double underlined and further deletions are shown by strike-through. Many of our suggested additions and deletions are purely verbal—minor corrections, clarifications, changes for consistency, etc. These are generally self-explanatory. More substantive changes are discussed in bold italics below or, in some cases, in the text of our accompanying letter.

* * * * *

Margin Requirements

Rule 431. (a) through (f) unchanged.

Portfolio Margin [and Cross-Margin]

(g) As an alternative to the "strategy" based margin requirements set forth in sections (a) through (f) of this Rule, member organizations may elect to apply the portfolio margin requirements set forth in this section (g) to [1) listed, broad-based U.S. index options, index warrants and underlying instruments and 2) listed security futures contracts and listed single stock options] all margin ~~eligible~~ equity securities[4] (as defined in Section 220.2 of Regulation T), listed options, OTC derivatives, and ~~U.S.~~ security futures[5] products (as defined in Section

[4] ~~For purposes of this section (g) of the Rule, the term "margin eligible security" utilizes the definition at section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System, excluding a nonequity security.~~

[5] ~~For purposes of this section (g) of the Rule, the term "security future" utilizes the definition at section 3(a)(55) of the Exchange Act. [, excluding narrow-based indices.]~~

3(a)(56) of the Securities Exchange Act of 1934 (the "Exchange Act")), provided ~~certain~~ that the requirements ~~are met. (See~~ of section (g)(6)(~~C~~B)(1)~~)~~ of this Rule are met.

Comment: We have suggested using the term "security futures products" because it encompasses both "security futures" as defined in section 3(a)(55) of the Exchange Act as well as options on security futures, which are also intended to be "eligible products." Also, the CBOE filing has eliminated the restriction to "U.S." security futures and we suggest corresponding changes above, in the following paragraph and elsewhere.

In addition, a member organization~~s~~, provided ~~they are~~ that it is a Futures Commission Merchant ("FCM") and ~~are~~ is either a clearing member of a futures clearing organization or ~~have~~ has an affiliate that is a clearing member of a futures clearing organization, ~~are~~ is permitted under this section (g) to combine an eligible participant's related instruments (as defined in section (g)(2)(D)) [(C)], with listed~~,~~ [broad-based] ~~U.S.~~ index options, options on exchange traded funds ("ETFs"), index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis. [("cross-margin"). Member organizations must confine cross-margin positions to a portfolio margin account dedicated exclusively to cross-margining.]

The portfolio margin [and cross-margining] provisions of this Rule shall not apply to Individual Retirement Accounts ("IRAs").

(1) Member organizations must monitor the risk of portfolio margin accounts and maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member organization's capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology [shall be made available to] must be approved by the Securities and

Exchange Commission ("SEC") or by the New York Stock Exchange ("Exchange") (or the member organization's designated examining authority ("DEA"), if other than the Exchange) [upon request.] and submitted to the ~~Securities and Exchange Commission ("~~SEC~~")~~ prior to the implementation of portfolio margining.

Comment: In the relatively unusual case where a member organization of the NYSE has a DEA other than NYSE, it seems appropriate that the DEA should review and approve the methodology.

In performing the risk analysis of portfolio margin accounts required by this Rule, each member organization shall include [the following] in the written risk analysis methodology procedures and guidelines for:

(A) obtaining and reviewing the appropriate account documentation and financial information necessary for assessing the amount of credit to be extended to eligible participants.

(B) [(A) Procedures and guidelines for] the determination, review and approval of credit limits to each eligible participant, and across all eligible participants, utilizing a portfolio margin account[.],

(C) [(B) Procedures and guidelines for] monitoring credit risk exposure to the member organization from portfolio margin accounts, on both an [including] intra-day and end of day basis [credit risk], including the type, scope and frequency of reporting to senior management [related to portfolio margin accounts.],

Comment: In evaluating this standard, SIA expects that the Exchange will take into account that while firms have systems for monitoring intra-day credit risk, such firms that are prime brokers do so taking into account the inability to capture real-time trading information for trades executed through executing brokers.

(D) [(C) Procedures and guidelines for] the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate[.],

(E) [(D) Procedures providing for] the regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group[.],

(F) <u>managing the impact of credit extension related to portfolio margin accounts on the member organization's overall risk exposure,</u>

(G) <u>the appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded, and</u>

(H) <u>determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product.</u>

<u>Moreover, management must periodically review, in accordance with written procedures, the member organization's credit extension activities for consistency with these guidelines. Management must periodically determine if the data necessary to apply this section (g) is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.</u>

(2) Definitions.-- For purposes of this section (g), the following terms shall have the meanings specified below:

Comment: It would be helpful to put the definitions in alphabetical order. Lettering of subparagraphs could be omitted to avoid relettering if definitions are added or deleted.

(A) The term "listed option" means any option traded on a registered national securities exchange or automated facility of a registered national securities association.

(B) The term "OTC derivative" means any equity-based or equity index-based unlisted option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the SEC or by the Exchange (or the Member Organization's DEA, if other than the Exchange) and submitted to the SEC.

(C) [(B)] The term "underlying instrument" means a security or security index upon which any listed option, OTC derivative, ~~U.S.~~ security future, or broad-based ~~U.S.~~ index future is based. [long and short positions in an exchange traded fund or other fund product registered under the Investment Company Act of 1940, that holds the same securities, and in the same proportion, as contained in a broad-based index on which options are listed. In the case of a listed security futures contract, "underlying instrument" means listed single stock option on the same security and in the same proportion. The term "underlying instrument" shall not be deemed to include options on futures contracts, or unlisted instruments.]

(D) [(C)] The term "related instrument" within a security [an option] class or product group means broad-based ~~U.S.~~ index futures [contracts] and options on broad-based ~~U.S.~~ index futures [contracts] covering the same underlying instrument. The term "related instrument" does not include security futures or options on security futures.

(E) [(D)] The term "security [options] class" refers to all ~~securities~~ listed options, security futures products and OTC derivatives [options] covering the same underlying instrument and the underlying instrument itself.

(F) [(E)] The term "portfolio" means any eligible product, as defined in section (g)(6)~~(C)~~(B)(1), grouped with ~~their~~ its underlying instruments and related instruments.

[(F) The term "option series" relates to listed options and means all option contracts of the same type (either a call or a put) and exercise style, covering the same underlying instrument with the same exercise price, expiration date, and number of underlying units.]

(G) The term "product group" means two or more portfolios of the same type (see table in section (g)(2)(I) below) for which it has been determined by Rule 15c3-1a under the ~~Securities~~ Exchange Act ~~of 1934 ("Exchange Act")~~ that a percentage of offsetting profits may be applied to losses at the same valuation point.

(H) For purposes of portfolio margin [and cross-margin] requirements the term "equity", as defined in section (a)(4) of this Rule, includes the market value of any long or short [option] positions held in an eligible participant's [a customer's] account.

(I) The term "theoretical gains and losses" means the gain and loss in the value of individual eligible products and related instruments at ten [10] equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument. The magnitude of the valuation point range shall be as follows:

Portfolio Type	Up / Down Market Move (High & Low Valuation Points)
High Capitalization, Broad-based ~~U.S.~~ Market Index [Option][6]	6 +6% / -8%
Non-High Capitalization, Broad-based ~~U.S.~~ Market Index [Option][7]	+/- 10%
~~Margin Eligible Security, Listed Equity Option, Listed Narrow-based Index Option,~~ [Listed] ~~U.S. Security Future, and OTC Derivative~~ [Instrument] ~~(Including forward contracts and swaps)~~ [Listed Security Futures Contract and Listed Single Stock Option] Any other eligible product that is, or is based on, an equity security or a narrow-based index	+/- 15%

(3) Approved Theoretical Pricing Models.-- Theoretical pricing models must be approved by the SEC or by the Exchange (or the Member Organization's DEA, if other than the Exchange), [a Designated Examining Authority] and submitted to [reviewed by] the SEC [Securities and Exchange Commission ("The Commission")] in order to qualify[8]. [Currently, the theoretical model utilized by the Options Clearing Corporation ("The OCC") is the only model qualified pursuant to the Commission's Net Capital Rule. All member organizations shall obtain their theoretical values from the OCC.]

(4) Eligible Participants.-- The application of the portfolio margin provisions of this section (g)[, including cross-margining, is limited to] ~~include~~ is limited to the following:

6 In accordance with section (b)(1)(i)(B) of Rule 15c3-1a (Appendix A to Rule 15c3-1) under the Securities Exchange Act of 1934, 17 CFR 240.15c3-1a(b)(1)(i)(B).

7 See footnote above.

8 Currently, the theoretical model utilized by ~~t~~The Options Clearing Corporation ("OCC") is the only model qualified.

Comment: If the following list of Eligible Participants is complete, we see no reason to use the "includes" language, which is potentially vague. If it is intended that additional persons could qualify under other rules or be approved on a case-by-case basis, that should be made express.

(A) any broker or dealer registered pursuant to Section 15 of the [Securities] Exchange Act; [of 1934;]

(B) any member of a national futures exchange to the extent that listed index options hedge the member's index futures; and

(C) any person or entity not included in sections (g)(4)(A) and (g)(4)(B) above approved for writing uncovered options ~~or U.S.~~ and, if transactions in security futures ~~transactions~~ are to be included in the account, approval for such transactions is also required. However, an eligible participant under this section (g)(4)(C) may not establish or maintain positions in OTC derivatives unless minimum equity of at least five million dollars is established and maintained with the member organization; provided, however, that the Exchange (or the member's DEA, if other than the Exchange) may exempt specific transactions or classes of transactions from this requirement if the limited risk characteristics of such transactions make the $5 million equity requirement unnecessary.

Comment: The SIA proposes this change in order to preserve some flexibility to waive the five million dollar minimum equity requirement with respect to particular transactions where the Exchange determines that the risk characteristics of the transactions do not require a five million dollar equity amount. An example might be a European-style collar transaction where the account holds the underlying stock.

[any other person or entity not included in sections (g)(4)(A) and (g)(4)(B) above that has or establishes, and maintains, equity of at least five million dollars.] For purposes of this minimum equity requirement, all securities and futures accounts carried by the member organization for the same eligible participant may be combined provided ownership across the accounts is identical. A guarantee pursuant to section (f)(4) of this Rule is not permitted for purposes of the minimum equity requirement.

Comment: The SIA urges the Exchange and the Commission to reconsider the prohibition against considering guarantees where the guarantor meets the minimum equity requirement and is an affiliate of the owner of the guaranteed account.

[For those accounts that are solely limited to listed security futures contracts and listed single stock options, the five million dollar equity requirement shall be waived.]

(5) Opening of Accounts.

(A) Member organizations must notify and receive approval from the Exchange or the member organization's DEA, if other than the Exchange, prior to establishing a portfolio margin [or cross-margin] methodology for eligible participants.

Comment: The above requirement seems more appropriately included under (g)(1).

(B) Only eligible participants that have been [approved for options transactions and] approved to engage in uncovered short option contracts or transactions in security futures pursuant to Exchange Rule 721, are permitted to utilize a portfolio margin account.

Comment: The addition of the double-underlined language above makes this section (g)(5)(B) consistent with (g)(4)(C).

(C) On or before the date of the initial transaction in a portfolio margin account, a member organization shall:

(1) furnish the eligible participant with a special written disclosure statement describing the nature and risks of portfolio margining [and cross-margining] which includes an acknowledgement for all portfolio margin account owners to sign, [and an additional acknowledgement for

owners that also engage in cross-margining to sign,] attesting that they have read and understood the disclosure statement, and agree to the terms under which a portfolio margin account [and the cross-margin account respectively, are] is provided (see Exchange Rule 726 (d)), and

(2) obtain the signed acknowledgement[(s)] noted above from the eligible participant [(both of which are required for cross-margining eligible participants)] and record the date of receipt.

(6) Establishing Account and Eligible Positions

(A) [Portfolio Margin Account.] For purposes of applying the portfolio margin requirements prescribed in this section (g), ~~and combining related instruments with listed, U.S. index options, options on exchange traded funds ("ETF"), index warrants, and underlying instruments,~~ member organizations are to establish and utilize a specific securities margin account, or sub-account of a margin account, clearly identified as a portfolio margin account that is separate from any other securities account carried for an eligible participant.

Comment: The deletion in subparagraph (6)(A)is suggested because the language appears to be surplusage.

[(B) Cross-Margin Account. For purposes of combining related instruments with listed, broad-based U.S. index options, index warrants, and underlying instruments, and applying the portfolio margin requirements, member organizations are to establish a cross-margin account that is separate from any other securities account or portfolio margin account carried for an eligible participant.]

A margin deficit in [either] the portfolio margin account [or the cross-margin account] of an eligible participant may not be considered as satisfied by excess equity in [the other] another account; provided, however, that if a portfolio margin account is carried as a subaccount of a margin account, excess equity in the margin account (determined in accordance with the rules applicable to a margin account other than a portfolio margin account) may be used to satisfy a margin deficit in the portfolio margin subaccount. Except as provided in the preceding sentence, ~~F~~funds and/or securities must be transferred to the deficient account and a written record created and maintained.

Comment: The proposed additions to the preceding paragraph seem to us implied by the very concept of a "subaccount" of a margin account and are, in our view, entirely appropriate.

(B) [(C)] [Portfolio Margin Account –] Eligible Products

(1) ~~For eligible participants as described in sections (g)(4)(A) through (g)(4)(C), a transaction in, or transfer of, an eligible product may be effected in the portfolio margin account.~~ In a portfolio margin account, an eligible participant may effect transactions and carry positions in any eligible product or a nonequity security; provided, however, that only eligible products may be margined on a portfolio margin basis. Nonequity securities may be included in a portfolio margin account solely for collateral purposes and shall be margined (*i.e.*, valued for collateral purposes) as provided in other provisions of this Rule 431.

Comment: Although it is our understanding that the SEC staff does not intend to permit portfolio margining of products other than equity and index products at this time, there seems to us no reason to prohibit an eligible participant from using nonequity securities as collateral in a portfolio margining account if they are valued as they would be under other provisions of Rule 431.

Eligible products under this section (g) consist of:

[(i) a listed, broad-based U.S. index option or index warrant and underlying instrument.

(ii) a listed security futures contract or listed single stock option.]

(i) a margin ~~eligible~~ equity security (including a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a "ready market" under SEC Rule 15c3-1 or a "no-action" position issued thereunder; and a control or restricted security, provided the security has met the requirements in a manner consistent with SEC Rule 144 or an SEC "no-action" position issued thereunder, sufficient to permit the sale of the security, upon exercise of any listed option or OTC derivative written against it, without restriction).

Comment: We have reorganized this list and provided some additional specificity for clarity. We have added the reference to warrants because we understand that they are included elsewhere in the rule. No substantive change from the current proposal is intended.

(ii) a listed option on an equity security or index of equity securities,

(iii) a security futures product,

~~an option on a security future, or~~

(iv) an OTC derivative on an equity security or index of equity securities,

(v) a warrant on an equity security or index of equity securities,

~~(ii) a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a "ready market" under SEC Rule 15c3-1 or a "no-action" position issued thereunder~~

~~(iii) a margin eligible control or restricted security, provided the security has met the requirements in a manner consistent with SEC Rule 144 or an SEC "no-action" position issued thereunder, sufficient enough to permit the sale of the security, upon exercise of any listed option or OTC derivative written against it, without restriction.~~

(vi) Any security convertible, exchangeable, or exercisable into a margin equity security, with or without additional consideration, or

(vii) a related instrument~~s~~ as defined in section (2)(D).

[(2) A transaction in, or transfer of, an underlying instrument may be effected in the portfolio margin account provided a position in an offsetting eligible product is in the account or is established in the account on the same day.

(3) A transaction in, or transfer of, a listed security futures contract or listed single stock option may also be effected in the portfolio margin account.]

(2) [(4)] ~~For eligible participants as described in section (g)(4)(C) that do not maintain five million dollars in equity, any~~ [Any] ~~long position or any short position in any~~ OTC derivative [eligible product] ~~that is no longer part of a hedge strategy must be transferred from the portfolio margin account to the appropriate securities account within ten business days, subject to any applicable margin requirement, unless the position becomes part of a hedge strategy again. Member organizations will be~~

~~expected to monitor portfolio margin accounts for possible abuse of this provision~~.

Comment: The deleted material above does not appear to be appropriate given that accounts with less than $5 million in equity are not eligible to hold OTC derivatives in the first place. To the extent that the intent is to specify the consequences when an account that is otherwise subject to the $5 million equity requirement falls below it, those provisions should be consolidated in subsection (g)(9).

~~Eligible debt securities under this subsection (g)(6)(B) shall consist of all "nonequity securities" as defined in Regulation T.~~

[(D) Cross-Margin Account – Eligible Products

(1) For eligible participants as described in sections (g)(4)(A) through (g)(4)(C), a transaction in, or transfer of, an eligible product may be effected in the cross-margin account.

(2) A transaction in, or transfer of, a related instrument may be effected in the cross-margin account provided a position in an offsetting eligible product is in the account or is established in the account on the same day.

(3) Any long position or any short position in any eligible product that is no longer part of a hedge strategy must be transferred from the cross-margin account to the appropriate securities account or futures account within ten business days, subject to any applicable margin requirement, unless the position becomes part of a hedge strategy again. Member organizations will be expected to monitor cross-margin accounts for possible abuse of this provision.]

(7) [Initial and Maintenance] Margin Required.-- The amount of margin required under this section (g) for each portfolio shall be the greater of:

(A) the amount for any of the ten [10] equidistant valuation points representing the largest theoretical loss as calculated pursuant to section (g)(8) below, or

(B) ~~for eligible participants as described in section (g)(4)(A) through (g)(4)(C), $.375 for each listed option, OTC derivative, U.S. security future, [contract] and related instrument, multiplied by the contract's or instrument's multiplier, not to exceed the market value in the case of long contracts [positions] in eligible products.~~

Comment: We have proposed in our comment letter two alternative procedures for determining a minimum margin requirement, either of which we believe to be more appropriate than the proposed fixed minimum margin of $.375 proposed in subparagraph (B) above.

(C) Account guarantees pursuant to section (f)(4) of this Rule are not permitted for purposes of meeting [initial and maintenance] margin requirements.

Comment: The SIA repeats its comment from page 9, and urges the Exchange and the Commission to reconsider this prohibition in the margin requirement context as well as in the equity requirement context. Rule 431 permits guarantees for maintenance margin purposes, and since Rule 431 supersedes Regulation T with respect to portfolio margin accounts, we see no reason that the Rule 431 standard should not apply. SIA believes it is appropriate to recognize for purposes of the margin requirement guaranteed portfolio margin accounts, at least where the guarantor is under common ultimate ownership.

(8) Method of Calculation.

(A) Long and short positions in eligible products ~~contracts, including underlying instruments and related instruments~~, are to be grouped ~~by security class; each security class group being [as] a "portfolio". Each portfolio is categorized as~~ in one of the portfolio types specified in section (g)(2)(I) above as applicable.

(B) For each portfolio, theoretical gains and losses are calculated for each position as specified in section (g)(2)(I) above. For purposes of determining the theoretical gains and losses at each valuation point, member organizations shall obtain and utilize the theoretical values of eligible products as described in this section (g) rendered by an approved theoretical pricing model.

(C) Offsets. Within each portfolio, theoretical gains and losses may be netted fully at each valuation point. Offsets between portfolios within the eligible product groups, as described in section (g)(2)(I), may then be applied as permitted by Rule 15c3-1a under the [Securities] Exchange Act [of 1934].

(D) After applying the offsets above, the sum of the greatest loss from each portfolio is computed to arrive at the total margin required for the account (subject to the per contract minimum).

(9) Portfolio Margin Minimum Equity Deficiency [Call]

(A) If, as of the close of business, [at any time,] the equity in the portfolio margin [or cross-margin] account of an eligible participant as described in section (g)(4)(C), declines below the five million dollar minimum equity ~~required~~(if applicable), and is not restored to at least five million dollars within three business days [(T+3)] by a deposit of funds and/or securities, member organizations are prohibited from accepting [opening] new orders beginning on the fourth business day, [starting on T+4,] except that [opening] new orders entered for the purpose of ~~hedging existing positions~~ reducing market risk may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until,

(1) equity of five million dollars is established[.] or,

(2) ~~any~~ all OTC derivatives ~~is~~ are liquidated or transferred from the portfolio margin account to the appropriate securities account. [For those

accounts that are solely limited to security futures contracts and single stock options, the five million dollar equity requirement shall be waived.]

(B) Member organizations will not be permitted to deduct any portfolio margin minimum equity deficiency [call] amount from Net Capital in lieu of collecting the minimum equity required.

(10) Portfolio Margin [Maintenance] Deficiency [Call]

(A) If, as of the close of business, [at any time,] the equity in the portfolio margin [or cross-margin] account of an eligible participant, as described in section (g)(4)(A) through (g)(4)(C), is less than the margin required, the eligible participant may deposit additional margin or establish a hedge to meet the margin requirement within three business days [(T+3)]. After [During] the three business day period, member organizations are prohibited from accepting [opening] new orders, except that [opening] new orders entered for the purpose of ~~hedging existing positions~~ reducing market risk may be accepted if the result would be to lower margin requirements. In the event an eligible participant fails to hedge existing positions or deposit additional margin in an amount sufficient to eliminate any margin deficiency after [within] three business days, the member organization must liquidate positions in an amount sufficient to, at a minimum, lower the total margin required to an amount less than or equal to the account equity.

(B) If the portfolio margin [maintenance] deficiency [call] is not met by the close of business on the next business day after the business day on which such deficiency arises, [T+1,] member organizations will be required to deduct the amount of the deficiency from Net Capital [the amount of the call] until such time as the deficiency [call] is satisfied.

(C) Member organizations will not be permitted to deduct any portfolio margin [maintenance] deficiency [call] amount from Net Capital in lieu of collecting the margin required.

(D) The Exchange or the member organization's DEA, if other than the Exchange, may grant additional time for an eligible participant to meet a portfolio margin deficiency upon written request, which is expected to be granted in ~~unique~~ extraordinary circumstances only.

(E) Member organizations should not permit an eligible participant to make a practice of meeting a portfolio margin deficiency by liquidation.

Comment: This prohibition is not included in the CBOE rule filing. We believe that such a prohibition is appropriate only to the extent that it is intended to prohibit abuses and should not prohibit eligible participants from liquidating positions to eliminate deficiencies created by market movements.

(11) Determination of Value for Margin Purposes.-- For the purposes of this section (g), all eligible products ~~and related instrument positions~~ shall be valued at current market prices. Account equity for the purposes of [this] sections (g)(9)(A) and (g)(10)(A) shall be calculated separately for each portfolio margin [or cross-margin] account.

Comment: "Related instruments" are included in the list of "eligible products," hence we have suggested deleting the reference here as redundant.

(12) Net Capital ~~Treatment of~~ Limitation on Member's Right to Carry Portfolio Margin [and Cross-Margin] Accounts.

(A) No member organization that requires margin in any portfolio margin [eligible participant] account pursuant to section (g) of this Rule shall permit the aggregate [eligible participant] portfolio margin [and cross-margin initial and maintenance] requirements to exceed ten times its ~~Net Capital~~ [net capital] for any period exceeding three business days. The member organization shall, beginning on the fourth business day, cease opening new portfolio margin [and cross-margin] accounts until compliance is achieved.

(B) If, at any time, a member organization's aggregate [eligible participant] portfolio margin [and cross-margin] requirements exceed ten times its net capital, the member organization shall immediately transmit telegraphic or facsimile notice of such deficiency to the principal office of the Securities and Exchange Commission in Washington, D.C., the district or regional office of the Securities and Exchange Commission for the district or region in which the member organization maintains its principal place of business; and to the [New York Stock] Exchange.

(13) ~~Day Trading Requirements.~~ [The requirements of sub-paragraph (f)(8)(B) of this Rule - Day-Trading shall not apply to portfolio margin accounts including cross-margin accounts.] ~~Day trading is not permitted in portfolio margin accounts. Member organizations are expected to monitor portfolio margin accounts to detect and prevent circumvention of the day trading requirements.~~ The requirements of sub-paragraph (f)(8)(B) of this Rule - Day-Trading shall not apply to portfolio margin accounts.

Comment: We strongly believe that the prohibition against day trading in a portfolio margin account is inappropriate. We note that no such prohibition is included in the CBOE proposal, and that the firms are required to monitor intra-day market risk.

(14) [Cross-Margin Accounts –] Requirements to Liquidate

(A) A member organization is required ~~immediately~~ promptly either to liquidate, or transfer to another broker-dealer eligible to carry portfolio [cross-] margin accounts, all [eligible participant] portfolio [cross-] margin accounts that contain positions eligible for portfolio [cross-] margining if the member organization is:

(1) insolvent as defined in section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature;

(2) the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such debtor has been appointed;

(3) not in compliance with applicable requirements under the [Securities] Exchange Act [of 1934] or rules of the Securities and Exchange Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of eligible participant's securities; or

(4) unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

(B) Nothing in this section (14) shall be construed as limiting or restricting in any way the exercise of any right of a registered clearing agency to liquidate or cause the liquidation of positions in accordance with its by-laws and rules.

(15) Member organizations must ensure that portfolio margin accounts are in compliance with all other applicable Exchange rules promulgated in Rules 700 through 795.