SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52951; File No. SR-NYSE-2004-39)

December 14, 2005

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving a Proposed Rule Change and Partial Amendment No. 1 to Amend Exchange Rule 431 (Margin Requirements)

I. Introduction

On July 12, 2004, the New York Stock Exchange, Inc. (the "Exchange" or "NYSE") filed with the Securities and Exchange Commission ("SEC" or the "Commission") a proposed rule change to amend specified provision of Exchange Rule 431 (margin requirements) pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the "Exchange Act")[2] and Rule 19b-4 thereunder.[3] On September 29, 2005, the Exchange filed a partial amendment to its proposed rule change.[4] The proposed rule change, as amended, was published for comment in the Federal Register on November 10, 2005.[5] The Commission received no comments on the proposal.

II. Description

The Exchange has proposed amendments to Rule 431 (margin requirements) that will recognize specific additional complex option spread strategies and set margin requirements commensurate with the risk of such spread strategies. These complex spread strategies are a combination of two or more basic option spreads that are already covered under Exchange Rule 431. In addition, the Exchange has proposed the

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1 15 U.S.C. 78s(b)(1).

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

3 17 CFR 240.19b-4.

4 SR-NYSE-2004-39: Amendment No. 1. The NYSE, in coordination with the Chicago Board Options Exchange, Incorporated ("CBOE"), filed the partial amendment to conform the complex options spreads strategies to which its rule amendments apply to those of the CBOE.

5 See Securities Exchange Act Release No. 52738 (Nov. 4, 2005); 70 FR 68501 (Nov. 10, 2005).

elimination of the two-dollar standard exercise price interval limitation for listed options and certain terminology with respect to “permitted offsets,” as defined in its Rule. The proposed amendments described below have been developed in conjunction with the Chicago Board Options Exchange (“CBOE”).

A. Complex Option Spreads

As noted, the Exchange has proposed amendments to Rule 431 to recognize certain additional complex option spread strategies that are the net result of combining two or more spread strategies that are currently recognized in the Exchange’s margin rules. The netting of contracts in option series common to each of the currently recognized spreads in an aggregation reduces it to the complex spread strategies outlined below.

The Exchange states that basic option spreads can be paired in such ways that they offset each other in terms of risk. The total risk of the combined spreads is less than the sum of the risk of both spread positions if viewed as stand-alone strategies. The specific complex spread strategies listed below are structured using the same principles as, and are essentially expansions of, the advanced spreads currently allowed in Rule 431.

Currently, Rule 431 recognizes and prescribes margin requirements for advanced spread strategies known as the “butterfly spread” and the “box spread.” However, the Exchange noted that these option spreads are limited in scope and that its proposal expands upon the types of pairings that would qualify for butterfly spread and box spread treatment.

Exchange Rule 431(f)(2)(G)(i) recognizes “calendar spreads,” also known as “time spreads,” but these spreads are not identified as such. The Exchange has proposed to define this term as “the sale of one option and the simultaneous purchase of an option with a more distant expiration date, both specifying the same underlying component with the same exercise price where the long options do not expire before the short option with the longest term expiration” in the definition section of the Rule (NYSE 431(f)(2)(C)) because some of the complex spreads recognized in this proposal will include this component of spread strategies.

The Exchange noted that to be eligible for the margin requirements in the proposal, a complex spread must be consistent with one of the seven patterns specified below. The expiration months and the sequence of the exercise prices must correspond to the same pattern, and the intervals between the exercise prices must be equal.

Under the proposal, members and member organizations will be required to obtain initial and maintenance margin for the subject complex spreads, whether established outright or through netting, of not less than the sum of the margin required on each basic spread in the equivalent aggregation.

The Exchange noted that the basic requirements for complex options spreads are as follows: (a) The complex spreads must be carried in a margin account; (b) European-style options are prohibited for complex spread combinations having a long option series that expires after the other option series. Only American-style options may be used in these combinations. Additionally, the intervals between exercise prices must be equal, and each complex spread must comprise four option series, with the exception of a Long Calendar Butterfly Spread, which must comprised of three option series.

According to the Exchange, the sum of the margin required on each currently recognized spread in each of the applicable aggregations renders a margin requirement for the subject complex spread strategies as stated below. The additional complex option strategies and maintenance margin requirements are as follows: (1) a Long Condor Spread comprised of two long Butterfly Spreads; (2) a Short Iron Butterfly Spread comprised of one long Butterfly Spread and one short Box Spread; (3) a Short Iron Condor Spread comprised of two long Butterfly Spreads and one short Box Spread; (4) a Long Calendar Butterfly Spread comprised of one long Calendar Spread and one long Butterfly Spread; (5) a Long Calendar Condor Spread comprised of one long Calendar Spread and two long Butterfly Spreads; (6) a Short Calendar Iron Butterfly Spread comprised of one long Calendar Spread plus one long Butterfly Spread and one short Box Spread; and (7) a Short Calendar Iron Condor Spread comprised of one Long Calendar Spread plus two long Butterfly Spreads and one short Box Spread.

The Exchange stated that the purpose and benefit of the proposal is to set levels of margin that more precisely represent the actual net risk of the option positions in the account and to enable customers to implement these strategies more efficiently.

B. Permitted Offsets

Currently, Exchange Rule 431(f)(2)(J) limits permitted offsets[6] for specialists and market makers in options to option series that are "in-or-at-the-money."[7] Recently, various options exchanges have provided for the listing of options with one-dollar strike intervals in a number of classes. The Exchange stated that as a result, the use of

[6] NYSE Rule 431(f)(2)(J) defines a permitted offset position as, in the case of an option in which a specialist makes a market, a position in the underlying asset or other related assets, and in the case of other securities in which a specialist makes a market, a position in options overlying the securities in which a specialist makes a market.

[7] NYSE Rule 431(f)(2)(J) defines the term "in or at the money" as the current market price of the underlying security is not more than two standard exercise intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option.

securities to hedge option series that have one-dollar strike intervals has unintentionally become more restrictive.

The Exchange has proposed a rule change to eliminate the two-dollar standard exercise price interval limitation for listed options and the definition of "in-or-at-the-money." As proposed, Rule 431(f)(2)(J) would require permitted offset transactions be effected for specialist or market-making purposes such as hedging, risk reduction, rebalancing of positions, liquidation, or accommodation of customer orders, or other similar specialist or market-making purposes, while prohibiting trading in an underlying security that is not related to specialist or market making option activities, or that does not constitute a reasonable hedge.

Because clearing firms have risk monitoring systems that alert them to unhedged positions and haircut requirements pursuant to Rule 15c3-1[8] of the Exchange Act[9] perform a similar function as NYSE margin requirements relative to providing adequate risk coverage to broker-dealers, the Exchange believes that the elimination of the two-dollar standard exercise price limitation and definition of "in-or-at-the-money" will not diminish the "safety and soundness" protections that Rule 431 provides.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[10] In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Exchange

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8 17 CFR 240.15c3-1.

9 15 U.S.C. 78a.

10 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

Act,[11] which requires that the rules of the exchange be designed, among other things, to remove impediments to and perfect the mechanisms of a free and open market, and, in general, to protect investors and the public interest. The Commission finds that amending the rules to permit complex option spread strategies that are the net result of combining two or more spread strategies that are currently recognized in the Exchange's margin rules is consistent with the requirements of Section 6(b)(5) because the amendments will allow the Exchange to set levels of margin that more precisely represent the actual net risk of the option positions in the account and enable customers to implement these strategies more efficiently.

The Commission further finds elimination of the two-dollar standard exercise price interval limitation for listed options and elimination of the definition of "in-or-at-the-money" are consistent with the requirements of Section 6(b)(5). The rules changes should allow specialists and market makers to hedge risk related to their options positions while prohibiting trading in an underlying security that is not related to specialist or market making option activities, or that does not constitute a reasonable hedge.

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[11] 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[12] that the proposed rule change (File No. SR-NYSE-2004-39), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[13]

Jonathan G. Katz
Secretary

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12 15 U.S.C. 78s(b)(2).

13 17 CFR 200.30-3(a)(12).