

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54919; File No. SR-CBOE-2006-14)

December 12, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment Nos. 1 and 2 to the Proposed Rule Change Relating to Customer Portfolio Margining; Order Granting Accelerated Approval to the Proposed Rule Change, as Amended

I. Introduction

On February 2, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 19b-4² thereunder, a proposed rule change seeking to amend CBOE Rule 12.4 to expand the scope of products that are eligible for treatment as part of CBOE’s approved portfolio margin pilot program and to eliminate the requirement for a separate cross-margin account.³ The proposed rule change would

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 52032 (July 14, 2005), 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03). On July 14, 2005, the Commission approved on a pilot basis expiring July 31, 2007, amendments to CBOE’s margin rules that permit broker-dealers to determine customer margin requirements for portfolios of listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds using a specified portfolio margin methodology. The Commission also approved rule amendments to require disclosure to, and written acknowledgment from, customers using a portfolio margin account.

expand the scope of eligible products in the pilot to include margin equity securities,⁴ unlisted derivatives, listed options and securities futures.⁵ The proposed rule change was published in the Federal Register on April 6, 2006.⁶ The Commission subsequently extended the comment period for the original proposed rule filing until May 11, 2006.⁷ The Commission received 7 comment letters in response to the Federal Register notice.⁸

⁴ For purposes of the pilot, a margin equity security is a security that meets the definition of a “margin equity security” under Regulation T of the Federal Reserve Board (“FRB”). See 12 CFR 220.2. An unlisted derivative means “any equity-based (or equity index-based) unlisted option, forward contract or swap that can be valued by a theoretical pricing model approved by the Securities and Exchange Commission.” See proposed Rule 12.4(a)(4).

⁵ In addition to CBOE Rule 12.4, the proposed rule change also approves changes to CBOE Rules 9.15, 13.5 and 15.8A.

⁶ See Exchange Act Release No. 53576 (March 30, 2006), 71 FR 17519 (April 6, 2006) (SR-CBOE-2006-14). The New York Stock Exchange LLC (“NYSE”) also filed a similar proposed rule filing seeking to expand the scope of eligible products under its portfolio margin pilot program. See Exchange Act Release No. 53577 (March 30, 2006), 71 FR 17539 (April 6, 2006) (SR-NYSE-2006-13).

⁷ See Exchange Act Release No. 53728 (April 26, 2006), 71 FR 25878 (May 2, 2006).

⁸ See letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy Morris, Secretary, Commission, dated June 5, 2006 (“CBOE Letter”); letter from William H. Navin, Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation (“OCC”), to Nancy M. Morris, Secretary, Commission, dated May 19, 2006 (“OCC Letter”); letter from James Barry, on behalf of the Ad Hoc Portfolio Margin Committee, John Vitha, Chair, Derivatives Product Committee and Christopher Nagy, Chair, Options Committee, Securities Industry Association, to Nancy M. Morris, Secretary, dated May 16, 2006 (“SIA Letter”); letter from Gary Alan DeWaal, Group General Counsel and Director of Legal and Compliance, Fimat USA, LLC, to Nancy M. Morris, Secretary, Commission, dated May 11, 2006 (“Fimat Letter”); letter from Stuart J. Kaswell, Partner, Dechert LLP, Counsel for Federated Investors, Inc., to Nancy M. Morris, Secretary, Commission, dated May 10, 2006 (“Federated Letter”); letter from Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange Inc., to Jonathan G. Katz, Secretary, Commission, dated May 9, 2006 (“CME Letter”);

On July 26, 2006, CBOE filed a response to these comments.⁹ The comment letters and CBOE's response to the comments are summarized below. On August 9, 2006, CBOE filed Amendment No. 1 to the proposed rule change.¹⁰ On September 27, 2006, CBOE filed Amendment No. 2 to the proposed rule change.¹¹

This order provides notice of filing of Amendment Nos. 1 and 2 and solicits comments from interested persons on Amendment Nos. 1 and 2. This order also grants accelerated approval of the proposed rule change, as amended by Amendment Nos. 1 and 2.¹²

and letter from Gerard J. Quinn, Vice President and Associate General Counsel, SIA, to Nancy M. Morris, Secretary, Commission, dated April 21, 2006 ("SIA Extension Letter").

⁹ See letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy M. Morris, Secretary, Commission, dated July 26, 2006 ("CBOE Response").

¹⁰ CBOE filed Amendment No. 1 in response to comments received and to make other clarifying changes to the proposed rule filing. Amendment No. 1 replaced and superceded the original filing in its entirety.

¹¹ CBOE filed partial Amendment No. 2 to conform its day trading language to the NYSE rule language and to request accelerated approval. A clean copy of the proposed rule, as amended by Amendment Nos. 1 and 2, is attached to this order as Exhibit A.

¹² By separate order, the Commission also is approving a parallel rule filing by the NYSE (SR-NYSE-2006-13). Exchange Act Release No. 54918; see also supra note 6.

II. Description

a. Portfolio Margining

The proposed rule change consists of amendments to Rule 12.4 to include margin equity securities (as defined in Regulation T), unlisted derivatives, listed options and securities futures as eligible products for the portfolio margining pilot.¹³ The proposed rule change also includes amendments to eliminate the requirement of a separate cross-margin account. CBOE Rule 12.3 prescribes specific margin requirements for customers based on the type of securities held in their accounts.¹⁴ Outside the existing pilot program, CBOE's margin rules require that margin be calculated using fixed percentages, on a position-by-position basis. In contrast, the current portfolio margin pilot program permits a broker-dealer to calculate customer margin requirements by grouping all products in an account that are based on the same index or issuer into a single portfolio. For example, futures, options and exchange traded funds based on the S&P 500 would each be grouped in a portfolio and products based on IBM would be grouped into a separate portfolio.

The broker-dealer then calculates a customer's margin requirement by "shocking" each portfolio at different equidistant points along a range representing a potential

¹³ The list of eligible products under the pilot currently includes listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds.

¹⁴ The margin rules specify the amount of equity a customer must maintain in his or her margin account with respect to securities positions financed by the broker-dealer. The equity protects the broker-dealer in the event the customer defaults on the obligation to re-pay the financing and the broker-dealer is forced to liquidate the position at a loss.

percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. Currently, under the pilot, products of portfolios based on high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 6% and a decrease of 8%. Portfolios of products based on non-high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 10% and a decrease of 10%. The proposed rule change would continue to apply these shock ranges. Under the proposed amendments, portfolios of products based on an equity security or a narrow-based index would be shocked along a range spanning an increase of 15% and a decrease of 15%.¹⁵ In addition, as with the current pilot, a theoretical options pricing model would continue to be used to derive position values at each valuation point for the purpose of determining the gain or loss.¹⁶

The portfolio shocks described above result in a gain or loss for each instrument in a portfolio at each calculation point along the range. These gains and losses are netted to derive a potential portfolio-wide gain or loss for the point. The margin requirement for a portfolio is the amount of the greatest portfolio-wide loss among the calculation points. The margin requirements for each portfolio are added together to calculate the total

¹⁵ For example, under the pilot, a portfolio of single stock futures and listed equity options would be shocked at 10 equidistant points along a range bounded on one end by a 15% increase in the market value of the instrument and at the other end by a 15% decrease (i.e., at +/-3%, +/-6%, +/-9%, +/-12% and +/-15%).

¹⁶ Currently, the only model that qualifies is the OCC's Theoretical Intermarket Margining System (TIMS).

margin requirement for the portfolio margin account. This approach, in most cases, will generally lower customer margin requirements.¹⁷

The amount of margin (initial and maintenance) required with respect to a given portfolio would be the larger of: (1) the greatest portfolio-wide loss amount among the valuation point calculations; or (2) the sum of \$.375 for each option and future in the portfolio multiplied by the contract's or instrument's multiplier.¹⁸ The second computation establishes a minimum margin requirement to ensure that a certain level of margin is required from the customer in the event the greatest portfolio-wide loss among the valuation points is de minimis.

b. Expansion of Eligible Products

Under CBOE's proposed rule, products eligible for portfolio margining would be expanded to include margin equity securities (as defined under Regulation T),¹⁹ unlisted derivatives, listed options and securities futures. The unlisted derivatives would be included in a portfolio based on the underlying reference index or security. Individual

¹⁷ For example, the current required initial and maintenance margin requirements for an equity security are 50% and 25%, respectively. The market movement range to calculate the potential gains and losses under the proposed portfolio margin rule for equity securities is +/-15%.

¹⁸ The multiplier for a standard listed option is fixed by the options market on which the options series is traded. For example, a cash settled equity option generally has a multiplier of 100. Therefore, the minimum margin for one options contract would be \$37.50. The multipliers for different securities and futures products may vary.

¹⁹ Margin equity securities include certain foreign equity securities and options on foreign equity securities. See 12 CFR 220.2

equities and narrow-based index futures would be included in a portfolio shocked at a range spanning an increase of 15% and a decrease of 15%.

c. Margin Deficiency

The proposed rule change would require a customer to satisfy a margin deficiency in a portfolio margin account within three business days by depositing additional margin or effecting an offsetting hedge. The current pilot requires that a customer deposit additional margin by T+1. The proposed rule also would require a broker-dealer to deduct from its net capital the amount of any portfolio margin call not met by the close of business on T+1 and until the call is satisfied. Additionally, the proposal would further require a broker-dealer to have in place procedures to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and to take appropriate action when warranted.²⁰

d. \$5 Million Equity Requirement

The current pilot requires customers that are not broker-dealers or futures firms to maintain minimum account equity of \$5 million dollars. The proposed rule change would eliminate the \$5 million account equity requirement for all portfolio margin accounts, except those holding unlisted derivatives.²¹

e. Risk Management Methodology

The pilot requires member broker-dealers to monitor the risk of portfolio margin accounts and maintain a written risk analysis methodology for assessing potential risk to

²⁰ See proposed rule 12.4(i)(1).

²¹ See proposed rule 12.4(b)(3).

the firm's capital. This risk analysis methodology must be filed and maintained with CBOE. The proposed rule change strengthens these requirements by providing that, member organizations must file the risk analysis methodology with its firm's DEA and submit it to the Commission prior to implementation.²² The proposed rule change also requires the inclusion of additional procedures and guidelines as part of the methodology.²³

f. Cross-Margin Account

The proposed rule change would eliminate the requirement that portfolios with futures positions be held in a separate cross-margin account. Under the proposal, a customer would be permitted to use a single securities margin account for all eligible products. The Exchange and commenters have indicated that maintaining and monitoring two separate margin accounts would be operationally difficult and that it would be more efficient to hold all positions in one securities account.

g. Excess Equity and Collateral

CBOE also proposes to amend Rule 12.4 to add language allowing a customer to use excess equity in a regular margin account to meet a margin deficiency in a portfolio margin account without having to transfer any funds or securities where the portfolio margin account is a sub-account of the regular margin account. In addition, the proposed rule change adds language allowing positions (including nonequity securities and money

²² See proposed Rule 12.4(b), under which the broker-dealer must receive prior approval from its DEA prior to offering portfolio margining to its customers. As part of the approval process, CBOE will require a firm to demonstrate compliance with the risk management analysis rules.

²³ See proposed Rule 15.8A.

market mutual funds) not eligible for portfolio margin treatment to be carried in the portfolio margin account for their collateral value, subject to the margin requirements of a regular margin account.

h. Day Trading

The proposed rule change amends the day trading provisions of Rule 12.4 to provide that CBOE's day trading rules do not apply to portfolio margin accounts that have at least \$5 million equity, provided the member firm has the ability to monitor the intra-day risk associated with day trading. In addition, the proposed rule change would provide that day trading will not be deemed to have occurred whenever the position or positions day traded were part of a hedge strategy²⁴ that reduced the risk of the portfolio.

i. Risk Disclosure Statement

The proposed rule change eliminates the sample risk disclosure statement and acknowledgement in the rule text.²⁵

j. Hedged Positions

Under the pilot, an underlying security in a portfolio margin account must be removed from the account if it is no longer offset by an option position. The amendments propose to eliminate the requirement to remove instruments that are no

²⁴ A "hedge strategy" for purposes of the day trading restrictions on portfolio margining means a transaction or series of transactions that reduces or offsets a material portion of the risk in a portfolio.

²⁵ Instead the Exchange will send out a regulatory circular with the sample disclosure language. The Exchange made this change to avoid having to file a proposed rule change each time in the risk disclosure document is changed.

longer offset by options positions. CBOE made this change in response to comments that all positions eligible for a portfolio margin account, including underlying securities, should receive equal treatment. Moreover, CBOE noted that it would be operationally difficult to move positions in and out of the portfolio margin account based on whether they are currently being offset.

III. Summary of Comments Received and CBOE Response

The Commission received a total of 7 comment letters to the proposed rule change.²⁶ The comments, in general, were supportive. One commenter stated that it strongly supports “the significant step forward represented by the currently proposed changes.”²⁷ Another commenter stated that the portfolio margining of securities products will “help US brokers and exchanges compete more effectively with their overseas counterparts. . .and thereby increase the strength and liquidity of US markets.”²⁸ Each commenter, however, recommended changes to specific provisions of the proposed rule change.

Several commenters²⁹ submitted comments regarding the ability to use portfolio margin methodologies other than the method prescribed in the rule to calculate customer margin requirements. One commenter stated that the Commission has experience in approving proprietary market risk models for consolidated supervised entities (CSEs) and

²⁶ See supra note 8. One of the comment letters related to the extension of the comment period for the proposed rule change. See SIA Extension Letter.

²⁷ See SIA Letter.

²⁸ See Fimat Letter.

²⁹ See SIA Letter and OCC Letter; see also CME Letter (discussing SPAN).

OTC derivatives dealers.³⁰ The Exchange stated, however, that initially, the most prudent course is for all broker-dealers to utilize the rule's specified methodology and that in the longer term, proprietary risk models could be considered as alternatives.³¹

One commenter suggested that CBOE eliminate the requirement for a separate cross margin account and provide for one portfolio margin account for both futures and options; eliminate the requirement that stock must be hedged in order to be carried in a portfolio margin account; and eliminate the two-tiered per contract minimum margin requirement in favor of one overall minimum.³² The CBOE stated that it agrees with the proposed changes and believes they are operationally feasible. In response, CBOE made these changes in Amendment No. 1 to the proposed rule filing.³³

One commenter stated that portfolio margining should be expanded to include nonequity securities, interest rate derivatives, collateralized debt obligations and other similar non-equity related products, and foreign currency derivatives.³⁴ This commenter also requested that nonequity securities be permitted to be held in the portfolio margin account for collateral purposes only, subject to the other applicable margin

³⁰ See SIA Letter.

³¹ See CBOE Response, supra note 9.

³² See SIA Letter.

³³ CBOE also made these changes to maintain consistency with the NYSE filing.

³⁴ See SIA Letter.

requirements.³⁵ The Exchange noted that it agrees with the commenter to the extent that nonequity securities may serve as collateral in the portfolio margin account.³⁶

One commenter requested that CBOE and NYSE eliminate differences between the CBOE and NYSE risk disclosure documents. In response, CBOE (and the NYSE) amended the rule text to eliminate the risk disclosure language.³⁷

IV. Discussion and Commission Findings

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.³⁸ In particular, the Commission believes that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act³⁹ in that it is designed to perfect the mechanism of a free and open market and to protect investors and the public interest. The Commission notes that the proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency with respect to Exchange margin requirements and will better align margin requirements with actual risk.

³⁵ See SIA Letter.

³⁶ See Amendment No. 1; see also CBOE Response, supra note 9.

³⁷ Id.; see supra note 25.

³⁸ 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).

³⁹ 15 U.S.C. 78f(b)(5).

Under a portfolio margin system, offsets are fully realized, whereas under the Exchange's current margin rules, positions are margined independent of each other and offsets between them do not figure into the total margin requirement. A portfolio margin system recognizes the offsetting gains from positions that react favorably in market declines, while market rises are tempered by offsetting losses from positions that react negatively. Consequently, a portfolio margin approach can have a neutralizing effect on the volatility of margin requirements. Thus, a portfolio margin system may better align a customer's total margin requirement with the actual risk associated with the customer's positions taken as a whole. The Commission further notes portfolio margining may alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility.

Moreover, the Commission notes that approving the proposed rule change would enhance portfolio margining by permitting more products to be margined under this methodology. This is consistent with the amendments to Regulation T made by the FRB in 1998, which sought to advance the use of portfolio margining.⁴⁰ The Commission also believes that this expanded program for portfolio margining will serve to advance the development of even more risk-sensitive approaches to margining customer positions, including the use of internal models as advocated by commenters. The Commission

⁴⁰ Federal Reserve System, "Securities Credit Transactions; Borrowing by Brokers and Dealers," 63 FR 2806 (January 16, 1998); see also 12 CFR 220.1(b)(3)(i); see also letter from the FRB to James E. Newsome, Acting Chairman, Commodity Futures Trading Commission, and Laura S. Unger, Acting Chairman, Commission, dated March 6, 2001. The FRB concluded the letter by writing "the Board anticipates that the creation of securities futures products will provide another opportunity to develop more risk-sensitive, portfolio-based approaches for all securities, including securities options and securities futures products." Id.

intends to work with CBOE and the NYSE towards this objective after it gains experience with the portfolio margining system of this proposal.

The Commission believes that while the portfolio margining system in the proposed rule will have the effect of reducing customer margin (in most cases), the methodology is relatively conservative in that it requires positions to be shocked at specified market move ranges (e.g., +/-15% for individual equities) that represent potential future stress events. Essentially the same portfolio methodology has been used by broker-dealers to calculate haircuts on options positions for net capital purposes.⁴¹ Furthermore, the proposed requirement that a firm receive pre-approval from the Exchange prior to offering portfolio margining to its customers, coupled with the requirement for enhanced risk management procedures, is designed to ensure that only those firms with adequate controls would be eligible to implement a customer portfolio margining program.⁴²

CBOE also has requested that the Commission approve Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after publication of notice of the filing in the Federal Register. The Commission believes that the changes in Amendment Nos. 1 and 2 to the proposed rule change do not raise significant new or unique issues from those previously raised in the earlier portfolio margin rule filings.⁴³ The changes

⁴¹ See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

⁴² The proposed rules also would continue to require a minimum per contract charge of \$.375. The Commission also notes that the proposed rules contain a leverage test under which a broker-dealer cannot permit the amount of portfolio margin required of its customers to exceed 10 times the firm's net capital.

⁴³ See supra note 3.

proposed by the Exchange in Amendment Nos. 1 and 2 are designed to ensure consistency with the companion NYSE proposed rule filing and to respond to comments received as a result of the Federal Register notice.⁴⁴ The Commission believes that these proposed changes strengthen the proposed rule change.

Accordingly, the Commission finds good cause for approving Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Specifically, the Commission believes that it is consistent with Section 19(b)(2) of the Act⁴⁵ to approve Amendment Nos. 1 and 2 to CBOE's proposed rule change prior to the thirtieth day after publication of the notice of filing thereof in the Federal Register.

Uniform Effective Date

The Commission believes that approving the amendments on an accelerated basis will permit CBOE to begin the process of approving broker-dealers to implement portfolio margining and would allow firms to begin to make the necessary changes and upgrades to their systems, as well as their policies and procedures, in order to accommodate customer portfolio. The Commission, however, believes that if some firms receive CBOE approval to begin offering customer portfolio margining to customers before other firms, these other firms would be at a competitive disadvantage. Therefore, the Commission has determined to set a uniform effective date of April 2, 2007 for the

⁴⁴ See supra notes 6 and 7.

⁴⁵ 15 U.S.C. 78s(b)(2).

proposed rule change, as amended. As stated above, the Commission believes that setting a uniform effective date will avoid placing some firms at a competitive disadvantage and reduce confusion in the marketplace.

V. Solicitation of Comments of Amendment Nos. 1 and 2

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>);
- or
- Send e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-14 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2006-14. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule

change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submission should refer to File Number SR-CBOE-2006-14 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴⁶ that the proposed rule change (File No. SR-CBOE-2006-14), as amended, be and it hereby is, approved on an accelerated basis, on a pilot basis to expire on July 31, 2007. The effective date will be April 2, 2007.

By the Commission.

Florence E. Harmon
Deputy Secretary

⁴⁶ 15 U.S.C. 78s(b)(2).

Exhibit A

Chicago Board Options Exchange, Inc.

Chapter XII

Margins

Rule 12.4. Portfolio Margin

As an alternative to the transaction / position specific margin requirements set forth in Rule 12.3 of this Chapter 12, a member organization may require margin for all margin equity securities (as defined in Section 220.2 of Regulation T), listed options, unlisted derivatives, security futures products, and index warrants in accordance with the portfolio margin requirements contained in this Rule 12.4.

In addition, a member organization, provided it is a Futures Commission Merchant (“FCM”) and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this Rule 12.4 to combine a customer's related instruments (as defined below), listed index options, unlisted derivatives, options on exchange traded funds, index warrants, and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis. Application of the portfolio margin provisions of this Rule 12.4 to IRA accounts is prohibited.

(a) Definitions.

- (1) The term “listed option” shall mean any equity (or equity index-based) option traded on a registered national securities exchange or automated facility of a registered national securities association.

(2) The term “security future” means a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, to the extent that that term is defined in Section 3(a)(55) of the Securities Exchange Act of 1934.

(3) The term “security futures product” means a security future, or an option on any security future.

(4) The term “unlisted derivative” means any equity-based (or equity index-based) unlisted option, forward contract or swap that can be valued by a theoretical pricing model approved by the Securities and Exchange Commission.

(5) The term “option series” 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.

(6) The term “class” refers to all listed options, unlisted derivatives, security futures products, and related instruments that are based on the same underlying instrument, and the underlying instrument itself.

(7) The term “portfolio” means products of the same class grouped together.

(8) The term “related instrument” within a class or product group means index futures contracts and options on index futures contracts covering the same underlying instrument, but does not include security futures products.

(9) The term “underlying instrument” means a security or security index upon which any listed option, unlisted derivative, security futures product or related instrument is based. The term underlying instrument shall not be deemed to include futures contracts, options on futures contracts or underlying stock baskets.

(10) The term “product group” means two or more portfolios of the same type for which it has been determined by Rule 15c3-1a(b)(ii) under the Securities Exchange Act of 1934 that a percentage of offsetting profits may be applied to losses at the same valuation point.

(11) The terms “theoretical gains and losses” means the gain and loss in the value of each eligible position at 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 Market Index ¹	+6%/-8%
Non-High Capitalization, Broad-based Market Index ¹	+/-10%
Narrow-based Index ¹	+/-15%
Individual Equity ¹	+/-15%

¹ In accordance with sub-paragraph (b)(1)(i)(B) of Rule 15c3-1a under the Securities Exchange Act of 1934.

(b) Eligible Participants.

Any member organization intending to apply the portfolio margin provisions of this Rule 12.4 to its accounts must receive prior approval from its DEA. The member organization will be required to, among other things, demonstrate compliance with Rule 15.8A – Risk Analysis of Portfolio Margin Accounts, and with the net capital requirements of Rule 13.5 – Customer Portfolio Margin Accounts.

The application of the portfolio margin provisions of this Rule 12.4 is limited to the following customers:

- (1) any broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934;
- (2) any member of a national futures exchange to the extent that listed index options, unlisted derivatives, options on exchange traded funds, index warrants or underlying instruments hedge the member's related instruments, and
- (3) any person or entity not included in (b)(1) or (b)(2) above that is approved for writing uncovered options. However, such persons or entities may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member organization. For purposes of the five million dollar minimum equity requirement, all securities and futures accounts carried by the member organization for the same customer may be combined provided ownership across the accounts is identical. A guarantee by any other account for purposes of the minimum equity requirement is not permitted.

(c) Opening of Accounts.

- (1) Only customers that, pursuant to Rule 9.7, have been approved for writing uncovered options are permitted to utilize a portfolio margin account.
- (2) On or before the date of the initial transaction in a portfolio margin account, a member shall:
 - (A) furnish the customer with a special written disclosure statement describing the nature and risks of portfolio margining and which includes an acknowledgement for

all portfolio margin account owners to sign, attesting that they have read and understood the disclosure statement, and agree to the terms under which a portfolio margin account is provided, and

(B) obtain a signed acknowledgement from the customer and record the date of receipt.

(d) Establishing Account and Eligible Positions.

(1) For purposes of applying the portfolio margin requirements provided in this Rule 12.4, member organizations are to establish and utilize a dedicated 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 a customer.

A margin deficit in the portfolio margin account of a customer may not be considered as satisfied by excess equity in another account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained. In the case of a portfolio margin account carried as a sub-account of a margin account, excess equity in the margin account may be used to satisfy a margin deficiency in the portfolio margin sub-account without transferring funds and/or securities to the portfolio margin sub-account.

(3) Eligible Positions

(A)

(i) a margin 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 unlisted derivative written against it, without restriction).

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

(iii) a security futures product,

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

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

(vi) a related instrument.

(4) Positions other than those listed in (3)(A) above are not eligible for portfolio margin treatment. However, positions not eligible for portfolio margin treatment (except for ineligible related instruments) may be carried in a portfolio margin account subject to the margin required pursuant Rule 12.3 of this Chapter 12. Shares of a money market mutual fund may be carried in a portfolio margin account subject to the margin required pursuant to Exchange Rule 12.3 of this Chapter 12 provided that:

(i) the customer waives any right to redeem the shares without the member organization’s consent,

- (ii) the member organization (or, if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem the shares in cash upon request,
- (iii) the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request, and
- (iv) the member organization complies with the requirements of Section 11(d)(1) of the Securities Exchange Act of 1934 and Rule 11d1-2 thereunder.

(e) Initial and Maintenance Margin Required. The amount of margin required under this Rule 12.4 for each portfolio shall be the greater of:

- (1) the amount for any of the ten equidistant valuation points representing the largest theoretical loss as calculated pursuant to paragraph (f) below or
- (2) \$.375 for each listed option, unlisted derivative, security futures product, and related instrument multiplied by the contract or instrument's multiplier, not to exceed the market value in the case of long positions.

(f) Method of Calculation.

- (1) Long and short positions in eligible positions are to be grouped by class; each class group being a "portfolio". Each portfolio is categorized as one of the portfolio types specified in paragraph (a)(11) above.
- (2) For each portfolio, theoretical gains and losses are calculated for each position as specified in paragraph (a)(11) above. For purposes of determining the theoretical gains and losses at each valuation point, member organizations shall obtain and

utilize the theoretical value of a listed option, unlisted derivative, security futures product, underlying instrument, and related instrument rendered by a theoretical pricing model that has been approved by the Securities and Exchange Commission.¹

(3) Offsets. Within each portfolio, theoretical gains and losses may be netted fully at each valuation point.

Offsets between portfolios within the High Capitalization, Broad-Based Index Option, Non-High Capitalization, Broad-Based Index Option and Narrow-Based Index Option product groups may then be applied as permitted by Rule 15c3-1a under the Securities Exchange Act of 1934.

(4) After applying paragraph (3) 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).

(5) In addition, if a security that is convertible, exchangeable, or exercisable into a security that is an underlying instrument requires the payment of money or would result in a loss if converted, exchanged, or exercised at the time when the security is deemed an underlying instrument, the full amount of the conversion loss is required.

(g) Minimum Equity Deficiency. If, as of the close of business, the equity in the portfolio margin account declines below the five million dollar minimum equity required under Paragraph (b) of this Rule 12.4 and is not restored to the required level within three (3) business days by a deposit of funds or securities, or through favorable market action; member organizations are prohibited from accepting new orders beginning on the fourth

¹ Currently, the theoretical model utilized by the Options Clearing Corporation is the only model qualified.

business day, except that new orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until such time as:

- (1) the required minimum account equity is re-established or
- (2) all unlisted derivatives are liquidated or transferred from the portfolio margin account to the appropriate account.

In computing net capital, a deduction in the amount of a customer's equity deficiency may not serve in lieu of complying with the above requirements.

(h) Determination of Value for Margin Purposes. For the purposes of this Rule 12.4, all eligible positions shall be valued at current market prices. Account equity for the purposes of this Rule 12.4 shall be calculated separately for each portfolio margin account by adding the current market value of all long positions, subtracting the current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.

(i) Additional Margin.

- (1) If, as of the close of business, the equity in any portfolio margin account is less than the margin required, the customer may deposit additional margin or establish a hedge to meet the margin requirement within three business days. After the three business day period, member organizations are prohibited from accepting new orders, except that new orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. In the event a customer fails to deposit additional margin in an amount sufficient to eliminate any margin deficiency or hedge existing positions after 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 account equity.

Member organizations should not permit a customer to make a practice of meeting a portfolio margin deficiency by liquidation. Member organizations must have procedures in place to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and a member organization is expected to take appropriate action when warranted. Liquidations to eliminate margin deficiencies that are caused solely by adverse price movements may be disregarded.-

Guarantees by any other account for purposes of margin requirements is not permitted.

- (2) Pursuant to Rule 13.5 - Customer Portfolio Margin Accounts, if additional margin required is not obtained by the close of business on T+1, member organizations must deduct in computing net capital any amount of the additional margin that is still outstanding until such time as the additional margin is obtained or positions are liquidated pursuant to (i)(1) above.
- (3) A deduction in computing net capital in the amount of a customer's margin deficiency may not serve in lieu of complying with the requirements of (i)(1) above.
- (4) A member organization may request from its DEA an extension of time for a customer to deposit additional margin. Such request must be in writing and will be granted only in extraordinary circumstances.
- (5) The day trading restrictions promulgated under Rule 12.3(j) shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in

equity, provided a member organization has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under Rule 12.3(j), provided the member organization has the ability to apply the applicable day trading restrictions under that Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A "hedge strategy" for the purpose of this rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Member organizations are also expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements.

(j) Portfolio Margin Accounts - Requirement to Liquidate.

(1) A member organization is required immediately either to liquidate, or transfer to another broker-dealer eligible to carry related instruments within portfolio margin accounts, all customer portfolio margin accounts with positions in related instruments if the member is:

- (i) insolvent as defined in section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature;
- (ii) 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;
- (iii) 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 customers' securities; or

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

(2) Nothing in this paragraph (j) 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.

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(Note: the sample risk description document is deleted in its entirety)

Chapter 9

Doing Business with the Public

Rule 9.15. Delivery of Current Options Disclosure Documents and Prospectus

(a) no change

(b) no change

(c) The special written disclosure statement describing the nature and risks of portfolio margining and acknowledgement for customer signature, required by Rule 12.4(c)(2) shall be in a format prescribed by the Exchange or in a format developed by the member organization, provided it contains substantially similar information as the prescribed Exchange format and has received prior written approval of the Exchange.

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Chapter XIII

Net Capital

Rule 13.5. Customer Portfolio Margin Accounts

(a) No member organization that requires margin in any customer accounts pursuant to Rule 12.4 - Portfolio Margin shall permit gross customer portfolio margin requirements to exceed 1,000 percent of its net capital for any period exceeding three business days.

The member organization shall, beginning on the fourth business day of any non-compliance, cease opening new portfolio margin accounts until compliance is achieved.

(b) If, at any time, a member organization's gross customer portfolio margin requirements exceed 1,000 percent of its net capital, the member organization shall immediately transmit telegraphic or facsimile notice of such deficiency to the Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549; to 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 its Designated Examining Authority.

(c) If any customer portfolio margin account becomes subject to a call for additional margin, and all of the additional margin is not obtained by the close of business on T+1, member organizations must deduct in computing net capital any amount of the additional margin that is still outstanding until such time as it is obtained or positions are liquidated pursuant to Rule 12.4(i)(1).

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Chapter XV

Records, Reports and Audits

Rule 15.8A. Risk Analysis of Portfolio Margin Accounts

- (a) Each member organization that maintains any portfolio margin accounts for customers shall establish and maintain a comprehensive written risk analysis methodology for assessing and monitoring 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 must be filed with the member organization's Designated Examining Authority and submitted to the SEC prior to the implementation of portfolio margining.
- (b) Upon direction by the Department of Member Firm Regulation, each affected member organization shall provide to the Department such information as the Department may reasonably require with respect to the member organization's risk analysis for any or all of the portfolio margin accounts it maintains for customers.
- (c) In conducting the risk analysis of portfolio margin accounts required by this Rule 15.8A, each member organization shall include in the written risk analysis methodology required pursuant to paragraph (a) above procedures and guidelines for:
- (1) obtaining and reviewing the appropriate customer account documentation and financial information necessary for assessing the amount of credit extended to customers,

- (2) the determination, review and approval of credit limits to each customer, and across all customers, utilizing a portfolio margin account,
- (3) monitoring credit risk exposure to the member organization from portfolio margin accounts, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management,
- (4) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate,
- (5) the regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group,
- (6) managing the impact of credit extension on the member organization's overall risk exposure,
- (7) the appropriate response by management when limits on credit extensions have been exceeded, and
- (8) 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 position(s).

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 Rule 15.8A is accessible on a timely basis and information systems are available to capture, monitor, analyze and report relevant data.