

Dated: December 17, 2004.

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[FR Doc. 04-28159 Filed 12-23-04; 8:45 am]

BILLING CODE 6820-MA-M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50886; File No. SR-CBOE-2002-03]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Incorporated Relating to Customer Portfolio and Cross-Margining Requirements

December 20, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on April 2, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") Amendment No. 1³ to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. The CBOE submitted the original proposed rule change to the Commission on January 15, 2002 ("Original Proposal"). The proposed rule change was published in the **Federal Register** on March 29, 2002.⁴ The Commission received one comment letter in response to the proposed rule change.⁵ The CBOE is proposing Amendment No. 1 to make corrections or clarifications to the proposed rule, or to reconcile differences between the proposed rule and a parallel filing by the NYSE.⁶ The Commission is publishing this notice to

solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to amend its rules, for certain customer accounts, to allow member organizations to margin listed, broad-based, market index options, index warrants and related exchange-traded funds according to a portfolio margin methodology as an alternative to the current strategy-based margin methodology. The proposed rule change also will provide for cross-margining by allowing broad-based index futures and options on such futures to be included with listed, broad-based index options, index warrants and related exchange-traded funds for portfolio margin treatment, in a separate cross-margin account. The text of the proposed rule change is below. Additions are in *italics*. Deletions are in *brackets*.

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Chapter XII Margins

[Covered Options Contracts]

Portfolio Margin and Cross-Margin for Index Options

Rule 12.4. [Deleted January 15, 1975.] *As an alternative to the transaction / position specific margin requirements set forth in Rule 12.3 of this Chapter 12, members may require margin for listed, broad-based U.S. index options, index warrants and underlying instruments (as defined below) in accordance with the portfolio margin requirements contained in this Rule 12.4.*

In addition, members, provided they are a Futures Commission Merchant ("FCM") and are either a clearing member of a futures clearing organization or have an affiliate that is a clearing member of a futures clearing organization, are permitted under this Rule 12.4 to combine a customer's related instruments (as defined below) and listed, broad based U.S. index options, index warrants and underlying instruments and compute a margin requirement ("cross-margin") on a portfolio margin basis. Members must confine cross-margin positions to a portfolio margin account dedicated exclusively to cross-margining.

Application of the portfolio margin and cross-margining provisions of this Rule 12.4 to IRA accounts is prohibited.

(a) Definitions.

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

(2) The term "unlisted option" means any option not included in the definition of listed option.

(3) The term "options class" refers to all options contracts covering the same underlying instrument.

(4) The term "portfolio" means options of the same options class grouped with their underlying instruments and related instruments.

(5) 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.

(6) The term "related instrument" within an option class or product group means futures contracts and options on futures contracts covering the same underlying instrument.

(7) The term "underlying instrument" means 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. The term underlying instrument shall not be deemed to include, futures contracts, options on futures contracts, underlying stock baskets, or unlisted instruments.

(8) The term "product group" means two or more portfolios of the same type (see subparagraph (a)(9) below) for which it has been determined by Rule 15c3-1a under the Securities Exchange Act of 1934 that a percentage of offsetting profits may be applied to losses at the same valuation point.

(9) The term "theoretical gains and losses" means the gain and loss in the value of individual option series and related instruments 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:

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Richard Lewandowski, Vice President, Division of Regulatory Services, CBOE, to Michael A. Macchiaroli, Associate Director, Division of Market Regulation ("Division"), Commission, dated April 1, 2004 ("Amendment No. 1").

⁴ See Securities Exchange Act Release No. 45630 (March 22, 2002), 67 FR 15263 (March 29, 2002).

⁵ See E-mail from Mike Ianni, Private Investor to rule-comments@sec.gov, dated November 7, 2002 ("Ianni E-mail").

⁶ See Securities Exchange Act Release No. 46576 (October 1, 2002), 67 FR 62843 (October 8, 2002) (File No. SR-NYSE-2002-19) ("NYSE Proposal").

Portfolio type	Up/Down market move (high & low valuation points)
non-high capitalization, broad based U.S. market index option ¹	+/- 10%
high capitalization, broad based U.S. market index option ¹	+6%/- 8%

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

(b) **Eligible Participants.** The application of the portfolio margin provisions of this Rule 12.4, including cross-margining, is limited to the following:

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

(2) any affiliate of a self-clearing member organization;

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

(4) any other person or entity not included in (b)1 through (b)3 above that has or establishes, and maintains, equity of at least 5 million dollars. For purposes of this equity requirement, all securities and futures accounts carried by the member 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 to be permitted.

(c) **Opening of Accounts.**

(1) Only customers that, pursuant to Rule 9.7, have been approved for options transactions, and specifically approved to engage in uncovered short option contracts, 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 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 provided [see Rule 9.15(d)], and

B. obtain a signed acknowledgement(s) from the customer, both of which are required for cross-margining customers, and record the date of receipt.

(d) **Establishing Account and Eligible Positions.**

(1) **Portfolio Margin Account.** For purposes of applying the portfolio

margin requirements provided in this Rule 12.4, members 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.

(2) **Cross-Margin Account.** For purposes of combining related instruments and listed, broad-based U.S. index options, index warrants and underlying instruments and applying the portfolio margin requirements provided in this Rule 12.4, members are to establish and utilize a portfolio margin account, clearly identified as a cross-margin account, that is separate from any other securities account or portfolio margin account carried for a customer.

A margin deficit in either the portfolio margin account or the cross-margin account of a customer may not be considered as satisfied by excess equity in the other account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained.

(3) **Portfolio Margin Account—Eligible Positions**

(i) A transaction in, or transfer of, a listed, broad-based U.S. index option or index warrant may be effected in the portfolio margin account.

(ii) A transaction in, or transfer of, an underlying instrument may be effected in the portfolio margin account provided a position in an offsetting listed, broad-based U.S. index option or index warrant is in the account or is established in the account on the same day.

(iii) If, in the portfolio margin account, the listed, broad-based U.S. index option or index warrant position offsetting an underlying instrument position ceases to exist and is not replaced within 10 business days, the underlying instrument position must be transferred to a regular margin account, subject to Regulation T initial margin and the margin required pursuant to the other provisions of this chapter. Members will be expected to monitor portfolio margin accounts for possible abuse of this provision.

(iv) In the event that fully paid for long options and/or index warrants are the only positions contained within a

portfolio margin account, such long positions must be transferred to a securities account other than a portfolio margin account or cross-margin account within 10 business days, subject to the margin required pursuant to the other provisions of this chapter, unless the status of the account changes such that it is no longer composed solely of fully paid for long options and/or index warrants.

(4) **Cross-Margin Account—Eligible Positions**

(i) A transaction in, or transfer of, a related instrument may be effected in the cross-margin account provided a position in an offsetting listed, U.S. broad based index option, index warrant or underlying instrument is in the account or is established in the account on the same day.

(ii) If the listed, U.S. broad-based index option, index warrant or underlying instrument position offsetting a related instrument ceases to exist and is not replaced within 10 business days, the related instrument position must be transferred to a futures account. Members will be expected to monitor cross-margin accounts for possible abuse of this provision.

(iii) In the event that fully paid for long options and/or index warrants (securities) are the only positions contained within a cross-margin account, such long positions must be transferred to a securities account other than a portfolio margin account or cross-margin account within 10 business days, subject to the margin required pursuant to the other provisions of this chapter, unless the status of the account changes such that it is no longer composed solely of fully paid for long options and/or index warrants.

(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 10 equidistant valuation points representing the largest theoretical loss as calculated pursuant to paragraph (f) below or

(2) \$.375 for each listed index option and related instrument multiplied by the contract or instrument's multiplier, not to exceed the market value in the case of long positions in listed options and options on futures contracts.

(f) Method of Calculation.

(1) Long and short positions in listed options, underlying instruments and related instruments are to be grouped by option class; each option class group being a "portfolio". Each portfolio is categorized as one of the portfolio types specified in paragraph (a)(9) above.

(2) For each portfolio, theoretical gains and losses are calculated for each position as specified in paragraph (a)(9) above. For purposes of determining the theoretical gains and losses at each valuation point, members shall obtain and utilize the theoretical value of a listed index option, underlying instrument or related instrument rendered by a theoretical pricing model that, in accordance with paragraph (b)(1)(i)(B) of Rule 15c3-1a under the Securities Exchange Act of 1934, qualifies for purposes of determining the amount to be deducted in computing net capital under a portfolio based methodology.

(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 product group and the Non-High Capitalization, Broad Based Index Option product group 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).

(g) Equity Deficiency. If, at any time, equity declines below the 5 million dollar minimum required under Paragraph (b)(4) of this Rule 12.4 and is not brought back up to at least 5 million dollars within three (3) business days (T+3) by a deposit of funds or securities, or through favorable market action; members are prohibited from accepting opening orders starting on T+4, except that opening orders entered for the purpose of hedging existing positions may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until such time as an equity of 5 million dollars is established.

(h) Determination of Value for Margin Purposes. For the purposes of this Rule 12.4, all listed index options and related instrument 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 at any time, the equity in any portfolio margin account, including a cross-margin account, is less than the margin required, additional margin must be obtained within one business day (T+1). In the event a customer fails to deposit additional margin within one business day, the member 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. Exchange Rule 12.9—Meeting Margin Calls by Liquidation shall not apply to portfolio margin accounts. However, members will be expected to monitor the risk of portfolio margin accounts pursuant to the risk monitoring procedures required by Rule 15.8A. Guarantees by any other account for purposes of margin requirements are not to be permitted.

(2) The day trading requirements of Exchange Rule 12.3(j) shall not apply to portfolio margin accounts, including cross-margin accounts.

(j) Cross-Margin Accounts—Requirement to Liquidate.

(1) A member is required immediately either to liquidate, or transfer to another broker-dealer eligible to carry cross-margin accounts, all customer cross-margin accounts that contain positions in futures and/or options on futures 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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Chapter XIII—Net Capital**Customer Portfolio Margin Accounts**

Rule 13.5. (a) No member organization that requires margin in any customer accounts pursuant to Rule 12.4—Portfolio Margin and Cross-Margin for Index Options, 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 Securities and Exchange Commission, 450 Fifth Street, NW., 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.

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Chapter XV Records, Reports and Audits**Risk Analysis of Portfolio Margin Accounts**

Rule 15.8A. (a) Each member organization that maintains any portfolio margin accounts for customers shall establish and maintain written procedures 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. Current procedures shall be filed and maintained with the Department of Financial and Sales Practice Compliance. The procedures shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the position(s) within the organization responsible for the risk function.

(b) Upon direction by the Department of Financial and Sales Practice Compliance, 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 affected member organization is required to follow the Interpretations and Policies set forth under Rule 15.8—Risk Analysis of Market-Maker Accounts. In addition, each affected member organization shall include in written procedures required pursuant to paragraph (a) above the following:

(1) Procedures and guidelines for the determination, review and approval of credit limits to each customer, and across all customers, utilizing a portfolio margin account.

(2) Procedures and guidelines for monitoring credit risk exposure to the member organization, including intra-day credit risk, related to portfolio margin accounts.

(3) 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.

(4) 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.

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Chapter 9 Doing Business With the Public

Delivery of Current Options Disclosure Documents and Prospectus

Rule 9.15. (a) no change

(b) no change

(c) no change

(d) The special written disclosure statement describing the nature and risks of portfolio margining and cross-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.

Sample Risk Description for Use by Firms to Satisfy Requirements of Exchange Rule 9.15(d)

Portfolio Margining and Cross-Margining Disclosure Statement and Acknowledgement

For a Description of the Special Risks Applicable to a Portfolio Margin Account and its Cross-Margining Features, See the Material Under Those Headings Below.

Overview of Portfolio Margining

1. Portfolio margining is a margin methodology that sets margin

requirements for an account based on the greatest projected net loss of all positions in a "product class" or "product group" as determined by an options pricing model using multiple pricing scenarios. These pricing scenarios are designed to measure the theoretical loss of the positions given changes in both the underlying price and implied volatility inputs to the model. Portfolio margining is currently limited to product classes and groups of index products relating to broad-based market indexes.

2. The goal of portfolio margining is to set levels of margin that more precisely reflect actual net risk. The customer benefits from portfolio margining in that margin requirements calculated on net risk are generally lower than alternative "position" or "strategy" based methodologies for determining margin requirements. Lower margin requirements allow the customer more leverage in an account.

Customers Eligible for Portfolio Margining

3. To be eligible for portfolio margining, customers (other than broker-dealers and certain non-broker-dealer affiliates of the carrying broker-dealer) must meet the basic standards for having an options account that is approved for uncovered writing and must have and maintain at all times account net equity of not less than \$5 million, aggregated across all accounts under identical ownership at the clearing broker. The identical ownership requirement excludes accounts held by the same customer in different capacities (e.g., as a trustee and as an individual) and accounts where ownership is overlapping but not identical (e.g., individual accounts and joint accounts).

Positions Eligible for a Portfolio Margin Account

4. All positions in broad-based U.S. market index options and index warrants listed on a national securities exchange, and exchange traded funds and other fund products registered under the Investment Company Act of 1940 that are managed to track the same index that underlies permitted index options, are eligible for a portfolio margin account.

Special Rules for Portfolio Margin Accounts

5. A portfolio margin account may be either a separate account or a subaccount of a customer's regular margin account. In the case of a subaccount, equity in the regular account will be available to satisfy any

margin requirement in the portfolio margin subaccount without transfer to the subaccount.

6. A portfolio margin account or subaccount will be subject to a minimum margin requirement of \$.375 multiplied by the index multiplier for every options contract or index warrant carried long or short in the account. No minimum margin is required in the case of eligible exchange traded funds or other eligible fund products.

7. Margin calls in the portfolio margin account or subaccount, regardless of whether due to new commitments or the effect of adverse market moves on existing positions, must be met within one business day. Any shortfall in aggregate net equity across accounts must be met within three business days. Failure to meet a margin call when due will result in immediate liquidation of positions to the extent necessary to reduce the margin requirement. Failure to meet an equity call prior to the end of the third business day will result in a prohibition on entering any opening orders, with the exception of opening orders that hedge existing positions, beginning on the fourth business day and continuing until such time as the minimum equity requirement is satisfied.

8. A position in an exchange traded index fund or other eligible fund product may not be established in a portfolio margin account unless there exists, or there is established on the same day, an offsetting position in securities options or other eligible securities. Exchange traded index funds and/or other eligible funds will be transferred out of the portfolio margin account and into a regular securities account subject to strategy based margin if, for more than 10 business days and for any reason, the offsetting securities options or other eligible securities no longer remain in the account.

9. When a broker-dealer carries a regular cash account or margin account for a customer, the broker-dealer is limited by rules of the Securities and Exchange Commission and of The Options Clearing Corporation ("OCC") in the extent to which the broker-dealer may permit OCC to have a lien against long option positions in those accounts. In contrast, OCC will have a lien against all long option positions that are carried by a broker-dealer in a portfolio margin account, and this could, under certain circumstances, result in greater losses to a customer having long option positions in such an account in the event of the insolvency of the customer's broker. Accordingly, to the extent that a customer does not borrow against long option positions in a portfolio margin

account or have margin requirements in the account against which the long option can be credited, there is no advantage to carrying the long options in a portfolio margin account and the customer should consider carrying them in an account other than a portfolio margin account.

Special Risks of Portfolio Margin Accounts

10. Portfolio margining generally permits greater leverage in an account, and greater leverage creates greater losses in the event of adverse market movements.

11. Because the time limit for meeting margin calls is shorter than in a regular margin account, there is increased risk that a customer's portfolio margin account will be liquidated involuntarily, possibly causing losses to the customer.

12. Because portfolio margin requirements are determined using sophisticated mathematical calculations and theoretical values that must be calculated from market data, it may be more difficult for customers to predict the size of future margin calls in a portfolio margin account. This is particularly true in the case of customers who do not have access to specialized software necessary to make such calculations or who do not receive theoretical values calculated and distributed periodically by The OCC.

13. For the reasons noted above, a customer that carries long options positions in a portfolio margin account could, under certain circumstances, be less likely to recover the full value of those positions in the event of the insolvency of the carrying broker.

14. Trading of securities index products in a portfolio margin account is generally subject to all the risks of trading those same products in a regular securities margin account. Customers should be thoroughly familiar with the risk disclosure materials applicable to those products, including the booklet entitled *Characteristics and Risks of Standardized Options*.

15. Customers should consult with their tax advisers to be certain that they are familiar with the tax treatment of transactions in securities index products.

16. The descriptions in this disclosure statement relating to eligibility requirements for portfolio margin accounts, and minimum equity and margin requirements for those accounts, are minimums imposed under exchange rules. Time frames within which margin and equity calls must be met are maximums imposed under exchange rules. Broker-dealers may impose their own more stringent requirements.

Overview of Cross-Margining

17. With cross-margining, index futures and options on index futures are combined with offsetting positions in securities index options and underlying instruments, for the purpose of computing a margin requirement based on the net risk. This generally produces lower margin requirements than if the futures products and securities products are viewed separately, thus providing more leverage in the account.

18. Cross-margining must be done in a portfolio margin account type. A separate portfolio margin account must be established exclusively for cross-margining.

19. When index futures and options on futures are combined with offsetting positions in index options and underlying instruments in a dedicated account, and a portfolio margining methodology is applied to them, cross-margining is achieved.

Customers Eligible for Cross-Margining

20. The eligibility requirements for cross-margining are generally the same as for portfolio margining, and any customer eligible for portfolio margining is eligible for cross-margining.

21. Members of futures exchanges on which cross-margining eligible index contracts are traded are also permitted to carry positions in cross-margin accounts without regard to the minimum aggregate account equity.

Positions Eligible for Cross-Margining

22. All securities products eligible for portfolio margining are also eligible for cross-margining.

23. All broad-based U.S. market index futures and options on index futures traded on a designated contract market subject to the jurisdiction of the Commodity Futures Trading Commission are eligible for cross-margining.

Special Rules for Cross-Margining

24. Cross-margining must be conducted in a portfolio margin account type. A separate portfolio margin account must be established exclusively for cross-margining. A cross-margin account is a securities account, and must be maintained separate from all other securities accounts.

25. Cross-margining is automatically accomplished with the portfolio margining methodology. Cross-margin positions are subject to the same minimum margin requirement for every contract, including futures contracts.

26. Margin calls arising in the cross-margin account, and any shortfall in aggregate net equity across accounts, must be satisfied within the same time

frames, and subject to the same consequences, as in a portfolio margin account.

27. A position in a futures product may not be established in a cross-margin account unless there exists, or there is established on the same day, an offsetting position in securities options and/or other eligible securities. Futures products will be transferred out of the cross-margin account and into a futures account if, for more than 10 business days and for any reason, the offsetting securities options and/or other eligible securities no longer remain in the account. If the transfer of futures products to a futures account causes the futures account to be undermargined, a margin call will be issued or positions will be liquidated to the extent necessary to eliminate the deficit.

28. According to the rules of the exchanges, a broker-dealer is required to immediately liquidate, or, if feasible, transfer to another broker-dealer eligible to carry cross-margin accounts, all customer cross-margin accounts that contain positions in futures and/or options on futures in the event that the carrying broker-dealer becomes insolvent.

29. Customers participating in cross-margining will be required to sign an agreement acknowledging that their positions and property in the cross-margin account will be subject to the customer protection provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 and the Securities Investor Protection Act, and will not be subject to the provisions of the Commodity Exchange Act, including segregation of funds.

30. In signing the agreement referred to in paragraph 29 above, a customer also acknowledges that a cross-margin account that contains positions in futures and/or options on futures will be immediately liquidated, or, if feasible, transferred to another broker-dealer eligible to carry cross-margin accounts, in the event that the carrying broker-dealer becomes insolvent.

Special Risks of Cross-Margining

31. Cross-margining must be conducted in a portfolio margin account type. Generally, cross-margining and the portfolio margining methodology both contribute to provide greater leverage than a regular margin account, and greater leverage creates greater losses in the event of adverse market movements.

32. As cross-margining must be conducted in a portfolio margin account type, the time required for meeting margin calls is shorter than in a regular securities margin account and may be shorter than the time ordinarily required

by a futures commission merchant for meeting margin calls in a futures account. As a result, there is increased risk that a customer's cross-margin positions will be liquidated involuntarily, causing possible loss to the customer.

33. As noted above, cross-margin accounts are securities accounts and are subject to the customer protections set forth in Rule 15c3-3 under the Securities Exchange Act of 1934 and the Securities Investor Protection Act. Cross-margin positions are not subject to the customer protection rules under the segregation provisions of the Commodity Exchange Act and the rules of the Commodity Futures Trading Commission ("CFTC") adopted pursuant to the Commodity Exchange Act.

34. Trading of index options and futures contracts in a cross-margin account is generally subject to all the risks of trading those same products in a futures account or a regular securities margin account, as the case may be. Customers should be thoroughly familiar with the risk disclosure materials applicable to those products, including the booklet entitled *Characteristics and Risks of Standardized Options* and the risk disclosure document required by the CFTC to be delivered to futures customers. Because this disclosure statement does not disclose the risks and other significant aspects of trading in futures and options, customers should review those materials carefully before trading in a cross-margin account.

35. Customers should bear in mind that the discrepancies in the cash flow characteristics of futures and certain options are still present even when those products are carried together in a cross-margin account. Both futures and options contracts are generally marked to the market at least once each business day, but the marks may take place with different frequency and at different times within the day. When a futures contract is marked to the market, the gain or loss is immediately credited to or debited from, respectively, the customer's account in cash. While an increase in value of a long option contract may increase the equity in the account, the gain is not realized until the option is sold or exercised. Accordingly, a customer may be required to deposit cash in the account in order to meet a variation payment on a futures contract even though the customer is in a hedged position and has experienced a corresponding (but as yet unrealized) gain on a long option. On the other hand, a customer who is

in a hedged position and would otherwise be entitled to receive a variation payment on a futures contract may find that the cash is required to be held in the account as margin collateral on an offsetting option position.

36. Customers should consult with their tax advisers to be certain that they are familiar with the tax treatment of transactions in index products, including tax consequences of trading strategies involving both futures and option contracts.

37. The descriptions in this disclosure statement relating to eligibility requirements for cross-margining, and minimum equity and margin requirements for cross-margin accounts, are minimums imposed under exchange rules. Time frames within which margin and equity calls must be met are maximums imposed under exchange rules. The broker-dealer carrying a customer's portfolio margin account, including any cross-margin account, may impose its own more stringent requirements.

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Acknowledgement for Customers Utilizing a Portfolio Margin Account—Cross-Margining and Non Cross-Margining—

Rule 15c3-3 under the Securities Exchange Act of 1934 requires that a broker or dealer promptly obtain and maintain physical possession or control of all fully-paid securities and excess margin securities of a customer. Fully-paid securities are securities carried in a cash account and margin equity securities carried in a margin or special account (other than a cash account) that have been fully paid for. Excess margin securities are a customer's margin securities having a market value in excess of 140% of the total of the debit balances in the customer's non-cash accounts. For the purposes of Rule 15c3-3, securities held subject to a lien to secure obligations of the broker-dealer are not within the broker-dealer's physical possession or control. The Commission staff has taken the position that all long option positions in a customer's portfolio-margining account (including any cross-margining account) may be subject to such a lien by OCC and will not be deemed fully-paid or excess margin securities under Rule 15c3-3.

The hypothecation rules under the Securities Exchange Act of 1934 (Rules 8c-1 and 15c2-1), prohibit broker-dealers from permitting the hypothecation of customer securities in a manner that allows those securities to be subject to any lien or liens in an amount that exceeds the customer's

aggregate indebtedness. However, all long option positions in a portfolio-margining account (including any cross-margining account) will be subject to OCC's lien, including any positions that exceed the customer's aggregate indebtedness. The Commission staff has taken a position that would allow customers to carry positions in portfolio-margining accounts (including any cross-margining account), even when those positions exceed the customer's aggregate indebtedness. Accordingly, within a portfolio margin account or cross-margin account, to the extent that you have long option positions that do not operate to offset your aggregate indebtedness and thereby reduce your margin requirement, you receive no benefit from carrying those positions in your portfolio margin account or cross-margin account and incur the additional risk of OCC's lien on your long option position(s).

BY SIGNING BELOW, THE CUSTOMER AFFIRMS THAT THE CUSTOMER HAS READ AND UNDERSTOOD THE FOREGOING DISCLOSURE STATEMENT AND ACKNOWLEDGES AND AGREES THAT LONG OPTION POSITIONS IN PORTFOLIO-MARGINING ACCOUNTS AND CROSS-MARGINING ACCOUNTS WILL BE EXEMPTED FROM CERTAIN CUSTOMER PROTECTION RULES OF THE SECURITIES AND EXCHANGE COMMISSION AS DESCRIBED ABOVE AND WILL BE SUBJECT TO A LIEN BY THE OPTIONS CLEARING CORPORATION WITHOUT REGARD TO SUCH RULES.

CUSTOMER NAME: _____

BY: _____

(signature/title)
DATE: _____

* * * * *

Acknowledgement for Customers Engaged in Cross-Margining

As disclosed above, futures contracts and other property carried in customer accounts with Futures Commission Merchants ("FCM") are normally subject to special protection afforded under the customer segregation provisions of the Commodity Exchange Act ("CEA") and the rules of the CFTC adopted pursuant to the CEA. These rules require that customer funds be segregated from the accounts of financial intermediaries and be separately accounted for, however, they do not provide for, and regular futures accounts do not enjoy the benefit of, insurance protecting customer accounts against loss in the event of the insolvency of the intermediary carrying the accounts.

As also has been discussed above, cross-margining must be conducted in a portfolio margin account dedicated exclusively to cross-margining, and cross-margin accounts are not treated as a futures account with an FCM. Instead, cross-margin accounts are treated as securities accounts carried with broker-dealers. As such, cross-margin accounts are covered by Rule 15c3-3 under the Securities Exchange Act of 1934, which protects customer accounts. Rule 15c3-3, among other things, requires a broker-dealer to maintain physical possession or control of all fully-paid and excess margin securities and maintain a special reserve account for the benefit of their customers. However, in respect of cross-margin accounts, there is an exception to the possession or control requirement of Rule 15c3-3 that permits The Options Clearing Corporation to have a lien on long positions. This aspect is outlined in a separate acknowledgement form that must be signed prior to or concurrent with this form. Additionally, the Securities Investor Protection Corporation ("SIPC") insures customer accounts against the financial insolvency of a broker-dealer in the amount of up to \$500,000 to protect against the loss of registered securities and cash maintained in the account for purchasing securities or as proceeds from selling securities (although the limit on cash claims is \$100,000). According to the rules of the exchanges, a broker-dealer is required to immediately liquidate, or, if feasible, transfer to another broker-dealer eligible to carry cross-margin accounts, all customer cross-margin accounts that contain positions in futures and/or options on futures in the event that the carrying broker-dealer becomes insolvent.

BY SIGNING BELOW, THE CUSTOMER AFFIRMS THAT THE CUSTOMER HAS READ AND UNDERSTOOD THE FOREGOING DISCLOSURE STATEMENT AND ACKNOWLEDGES AND AGREES THAT: 1) POSITIONS AND PROPERTY IN CROSS-MARGINING ACCOUNTS, WILL NOT BE SUBJECT TO THE CUSTOMER PROTECTION RULES UNDER THE CUSTOMER SEGREGATION PROVISIONS OF THE COMMODITY EXCHANGE ACT ("CEA") AND THE RULES OF THE COMMODITY FUTURES TRADING COMMISSION ADOPTED PURSUANT TO THE CEA, AND 2) CROSS-MARGINING ACCOUNTS THAT CONTAIN POSITIONS IN FUTURES AND/OR OPTIONS ON FUTURES WILL BE IMMEDIATELY LIQUIDATED, OR, IF

FEASIBLE, TRANSFERRED TO ANOTHER BROKER-DEALER ELIGIBLE TO CARRY CROSS-MARGIN ACCOUNTS, IN THE EVENT THAT THE CARRYING BROKER-DEALER BECOMES INSOLVENT.

CUSTOMER NAME: _____

BY: _____

(signature/title)

DATE: _____

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

a. Introduction

The CBOE proposes to expand its margin rules by providing a portfolio margin methodology for listed, broad-based market index options, index warrants and related exchange-traded funds that clearing member organizations may extend to eligible customers as an alternative to the current strategy-based option margin requirements. The proposed rule change would also allow broad-based index futures and options on such futures to be included in a separate portfolio margin account, thus providing a cross-margin capability. The CBOE seeks to introduce the proposed new rule as a two-year pilot program that would be made available to member organizations on a voluntary basis.

The proposed rule change would permit self-clearing member organizations to apply a prescribed portfolio margin methodology to an account⁷ of an affiliate, another broker-dealer, and an account of a member of a national futures exchange who is a futures floor trader. Any other customers of the clearing member would be required to have account equity of at least \$5 million to be eligible for portfolio margin treatment. This circumscribes the number of

accounts able to participate and adds safety in that such accounts are more likely to be of significant financial means and investment sophistication. Further, portfolio margining is most effective when applied to larger accounts with diverse option positions and related securities, and any related futures contracts. It is expected that institutional customers will be the primary participants. Whether the account equity requirement should be lowered to allow participation of more customers will be assessed at the end of the pilot program period. Application of portfolio margin, including cross-margin, to an IRA account would be prohibited under the proposed rule change.

A number of revisions contained in Amendment No. 1 were deemed warranted, or requested or recommended by staff of the Commission. In either case, the reason for these revisions is to make corrections or clarifications to the proposed rule, or to reconcile differences between the proposed rule and a parallel filing by the NYSE.⁸

The proposed portfolio margin and cross-margin rules have been developed by the CBOE in cooperation with The Options Clearing Corporation ("The OCC"), the New York Stock Exchange, Inc. ("NYSE"), the American Stock Exchange LLC ("AMEX"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), and the Chicago Mercantile Exchange Inc. ("CME"). The CBOE intends to provide a written overview describing the operational details of the portfolio margin and cross-margin pilot program to potential member organization participants to introduce and explain the pilot program.

A committee of representatives from the member organizations identified as potential participants, and staff of the sponsoring exchanges and The OCC (the "Portfolio Margin Committee") was formed and met several times in 1999 and 2000 to refine the portfolio margin and cross-margin pilot program. This group has recommended adoption of the portfolio margin and cross-margin pilot program, as finalized by the group, and the related rule proposals. In addition, the portfolio margin and cross-margin pilot program has been presented to the NYSE's Rule 431 Committee⁹ on two

⁸ See NYSE Proposal, *supra* note 6.

⁹ The NYSE Rule 431 Committee is comprised of securities industry representatives, primarily representatives of NYSE member organizations. NYSE Rule 431 contains the NYSE's margin rules. The function of the NYSE Rule 431 Committee is to assess the adequacy of NYSE Rule 431 on an ongoing basis, review proposals for changes to

⁷ An account dedicated to portfolio margining.

occasions, with draft rules included on the second occasion, and has received the NYSE's Rule 431 Committee's support.

b. Overview—Portfolio Margin Computation

(1) Portfolio Margin

Under a portfolio margin system, margin is required based on the greatest loss that would be incurred in a portfolio if the value of components (underlying instruments in the case of options) move up or down by a predetermined amount (e.g., $\pm 5\%$). Under the Exchange's proposed portfolio margin rule, listed index options and underlying instruments (also related instruments¹⁰ in the case of a cross-margin account) would be grouped by class¹¹ (e.g., S&P 500, S&P 100, etc.), each class group being a portfolio.¹² The gain or loss on each position in a portfolio would be calculated at each of 10 equidistant points ("valuation points") set at and between the upper and lower market range points. A theoretical options pricing model would be used to derive position values¹³ at each valuation point for the purpose of determining the gain or loss. Gains and losses would then be netted for positions within the class or portfolio at each valuation point. The greatest net loss among the 10 valuation points would be the margin required on the portfolio or class. The margin for all other portfolios within an account would be calculated in a similar manner. Broad-based index classes (portfolios) that are highly correlated would be allowed offsets such that, at the same valuation point, for example, 90% of a gain in one class may reduce or offset a loss in another class. The amount of offset allowed between portfolios would be the same amount that is permitted under the risk-based haircut methodology set forth in Appendix A of the Commission's net capital rule.¹⁴ A per contract minimum would be established and would

override if a lesser requirement is rendered by the portfolio margin computation.¹⁵ Member organizations would not be permitted to use any theoretical pricing model to generate the prices used to calculate theoretical profits and losses. Under the proposed rule change, the theoretical prices used for computing profits and losses must come from a theoretical pricing model that, pursuant to the Commission's net capital rule,¹⁶ qualifies for purposes of determining the amount to be deducted in computing net capital under a portfolio-based methodology. CBOE believes that delineating acceptable theoretical pricing models is best achieved by applying the Commission's net capital rule by reference. In this way, consistency with the Commission's net capital rule is maintained. In addition, since theoretical pricing models must be approved by a Designated Examining Authority ("DEA") and reviewed by the Commission to qualify, uniformity across models can be assured. As a result, portfolio margin and cross-margin requirements will not vary materially from firm to firm. Currently, the theoretical model used by The OCC is the only model qualified pursuant to the Commission's net capital rule. Consequently, all member organizations participating in the pilot program would, at least for the foreseeable future, obtain their theoretical values from The OCC.

The Exchange's proposed rule would propose a market range of $\pm 10\%$ for computing theoretical gains and losses in broad-based, non-high capitalization index portfolios. A market range of $+6\%/-8\%$ is proposed for broad-based, high capitalization index portfolios.¹⁷ These are the same ranges currently applied to options market makers for the purpose of computing portfolio or risk-based haircuts. On a historical basis, these ranges cover one day moves at a very high level of confidence, and would be competitive with the market range coverage applied for performance bond (margin) purposes in the futures industry on comparable index futures.

The proposed rule change requires that a separate securities margin account (or subaccount of a securities margin account) be used for portfolio margining.

Amendment No. 1 to the proposed rule change also adds rule language that requires fully paid for long options (and/or index warrants) to be transferred out of the portfolio margin account and/or cross-margin account and into a securities account that is not a portfolio margin account, in the event that such long positions are the only components.

(2) Cross-Margining

The proposed rule permits related index futures and options on such futures to be carried in a separate portfolio margin account, thus affording a cross-margin capability. Amendment No. 1 contains changes that primarily relate to the addition of rule language (i.e., Rule 12.4(j)) that, pursuant to agreement between Commission staff, the Exchange and The Options Clearing Corporation, requires cross-margin positions to be liquidated or transferred in the event the carrying broker-dealer becomes insolvent. The Original Proposal allowed cross-margining to be commingled with other, non-cross margin portfolio margin positions in the same account. However, the proposal of Amendment No. 1 to require liquidation or transfer of the cross-margin account necessitates that cross-margining be conducted in an account separate from non-cross-margining activity. Therefore, Amendment No. 1 contains a number of proposed revisions that relate to isolation of cross-margin positions in a separate account.

In a portfolio margin account, including one that is used exclusively for cross-margining, constituent portfolios may be formed containing index options, index warrants and exchange-traded funds structured to replicate the composition of the index underlying a particular portfolio, as well as related index futures and options on such futures. Cross-margining would operate similar to the cross-margin program that was approved by the Commission and the Commodity Futures Trading Commission ("CFTC") for listed options market-makers and proprietary accounts of clearing member organizations. For determining theoretical gains and losses, and resultant margin requirements, the same portfolio margin computation program will be applied to portfolio margin accounts, as well as cross-margin accounts.

NYSE Rule 431, and recommend changes that are deemed appropriate.

¹⁰ Under the proposed rule change, the term "related instrument" would mean, with respect to an options class or product group, futures contracts and options on futures contracts covering the same underlying instrument.

¹¹ Under the proposed rule change, the term "options class" would refer to all options contracts covering the same underlying instrument.

¹² CBOE's pilot program would permit an exchange-traded fund structured to replicate the composition of the index to be included; however, stock baskets would not be permitted at this time.

¹³ Position values would represent the difference between the position closing price and the theoretical value at each valuation point.

¹⁴ Rule 15c3-1a under the Act, 17 CFR 240.15c3-1a.

¹⁵ The proposed rules set a per contract minimum of \$37.50.

¹⁶ See Rule 15c3-1a(b)(1)(i)(B) under the Act, 17 CFR 240.15c3-1a(b)(1)(i)(B).

¹⁷ CBOE believes that it is imperative that these market move ranges be competitive with the range used in the futures industry for computing margin (performance bond) on broad-based index futures. The proposed ranges accomplish this goal. Customer performance bond in the futures industry is computed using a portfolio margining system known as the Standard Portfolio Analysis of Risk ("SPAN"). The terms "high capitalization" and "non-high capitalization" have the same meaning as they do for the purposes of risk-based haircuts (Rule 15c3-1 under the Act, 17 CFR 240.15c3-1).

c. Margin or Minimum Equity Deficiency

Under proposed CBOE Rule 12.4(h), positions in a portfolio margin account would be valued at current market prices, as currently defined in the Exchange's margin rules. Under the proposed rule change, account equity would be calculated and maintained separately for each portfolio margin account. For purposes of the \$5 million minimum account equity requirement, all accounts owned by an individual or entity may be combined. Proposed CBOE Rule 12.4(i) requires that additional margin must be obtained within one business day (T+1) whenever equity is below the margin required, regardless of whether the deficiency is caused by the addition of new positions, the effect of unfavorable market movement on existing positions, or a combination of both. The portfolio margin requirement, therefore, would be both the initial and maintenance margin requirement, and no differentiation would be necessary. In addition, proposed CBOE Rule 12.4(g) would require that, in the event account equity falls below the \$5 million minimum, additional equity must be deposited within 3 business days (T+3). If the deficiency were not resolved within 3 business days, the carrying member organization would be prohibited under the proposed rule change from accepting any new opening orders beginning on T+4, with the exception of opening orders that hedge existing positions. This prohibition would remain in effect until a \$5 million equity was established.

d. Risk Disclosure Statement and Acknowledgement

In addition, the Exchange proposes that member organizations provide every portfolio margin customer with a written risk disclosure statement at or prior to the initial opening of a portfolio margin account.¹⁸ This disclosure statement highlights the risks and operation of portfolio margin accounts, including cross-margining, and the differences between portfolio margin and strategy-based margin requirements. The disclosure statement is divided into two sections, one dealing with portfolio margining and the other with cross-margining. The disclosure statement clearly notes that additional leverage is possible in an account margined on a portfolio basis in relation to strategy-

based margin. Among other things, the disclosure statement covers who is eligible to open a portfolio margin account, the instruments that are allowed, and when deposits to meet margin and minimum equity are due. The fact that long option positions held in a portfolio margin account are not segregated, as they generally would be in the case of a regular margin account under the Commission's customer protection rules, is explained. Also included within the portfolio margin section is a summary list of the special risks of portfolio margin accounts, such as: increased leverage; shorter time for meeting margin; involuntary liquidation if margin not received; inability to calculate future margin requirements because of the data and calculations required; and that long positions are subject to a lien. The risks and operation of a cross-margin feature are outlined in the cross-margin section of the disclosure statement, and a summary list of the special risks associated with cross-margining is included.

Further, at or prior to the time a portfolio margin account is initially opened, member organizations would be required to obtain a signed acknowledgement concerning portfolio margining in general from the customer. In addition, prior to accommodating cross-margining, member organizations would be required to obtain a second signed acknowledgement within the same time frame that pertains to cross-margin.

By signing the general acknowledgement required of all customers, the customer would attest to having read the disclosure statement and being aware of the fact that long option positions in a portfolio margin account (which includes cross-margin accounts) are not subject to the segregation requirements under the customer protection rules of the Commission, and would be subject to a lien by the OCC. In signing the additional acknowledgement applicable to cross-margining, the customer would attest to having read the disclosure statement and being aware of the fact that futures positions are being carried in a securities account, are subject to the Commission's customer protection rules,¹⁹ and fall under the authority of the SIPC in the event the carrying broker-dealer becomes financially insolvent. Within Chapter 9 of the Exchange's rules ("Doing Business with

the Public"), the Exchange would prescribe the format of the written disclosure statement and acknowledgements in proposed Exchange Rule 9.15(d)—Delivery of Current Options Disclosure Documents and Prospectus. Like a current Exchange rule that prescribes the format for a Special Statement for Uncovered Options Writers (CBOE Rule 9.15(c)), proposed Exchange Rule 9.15(d) would allow member organizations to develop their own format, provided it contains substantially similar information and it is approved in advance by the Exchange.

e. Net Capital

The Exchange also proposes to add a new requirement in CBOE Rule 13.5 to mandate that the gross customer portfolio margin requirements of a broker-dealer may at no time exceed 1,000 percent of a carrying broker-dealer's net capital (a 10:1 ratio). This requirement is intended to place a ceiling on the amount of margin a broker-dealer can extend to its customers in relation to its net capital.

f. Internal Risk Monitoring Procedures

The Exchange further proposes a separate, related rule that would require member organizations that carry portfolio margin or cross-margin accounts to establish and maintain written procedures for assessing and monitoring the potential risks to their capital. Specifically, proposed CBOE Rule 15.8A (Risk Analysis of Portfolio Margin and Cross-Margin Accounts) would require that the member organization file and maintain its current procedures with its DEA, and provide the DEA with such information as the DEA may reasonably require regarding the member organization's risk analysis of any and all portfolio margin and cross-margin accounts carried for customers. Proposed CBOE Rule 15.8A would incorporate current Exchange Rule 15.8—Risk Analysis of Market-Maker Accounts—by reference to require that the risk analysis be conducted in the same manner as prescribed in Exchange Rule 15.8. Additionally, proposed CBOE Rule 15.8A would set forth certain undertakings that must be included in the written procedures (*e.g.*, review and approval of credit limits for each customer and across all accounts).

Because member organizations would be required under the proposed rule change to have risk monitoring procedures, proposed CBOE Rule 12.4(i) states that the current CBOE Rule 12.9—Meeting Margin Calls by Liquidation Prohibited—prohibiting excessive

¹⁸ Even a customer that engages exclusively in cross-margining is a portfolio margin customer, as the proposed rule change permits cross-margining to be conducted only by applying the portfolio margin methodology.

¹⁹ As disclosed in the general acknowledgement form (required of any portfolio or cross-margin customer), portfolio margin and cross-margin accounts operate pursuant to an exception to the customer protection rules in that fully paid long positions will not be segregated.

liquidations to meet margin requirements will not apply to portfolio margin and cross-margin accounts. Furthermore, given the proposed risk monitoring procedures, CBOE proposes that day trading margin requirements would not apply to portfolio margin and cross-margin accounts. Through these risk-monitoring procedures, member organizations will be expected to oversee portfolio margin and cross-margin accounts for excessive liquidations and day trading and take appropriate action according to their procedures.

It should be noted that the disclosure statement delivery requirement, the \$5 million minimum equity requirement, and the next day deposit condition for additionally required margin were all added by the Portfolio Margin Committee. The Portfolio Margin Committee deemed these requirements prudent given that less margin is generally required under a portfolio margining approach than under the current strategy-based methodology, and these measures made the plan entirely acceptable to the member firm representatives.

g. Margin at the Clearing House Level ²⁰

The Exchange proposes that all customer portfolio margin account transactions not involving a futures transaction (*e.g.*, cross-margin) be cleared in one special omnibus account for the clearing firm at The OCC. In addition, the Exchange proposes that all transactions involving cross-margining, both the security and futures products, be cleared in one of two additional special omnibus accounts for cross-margining, depending on the entity that clears the futures product being cross-margined. One cross-margin omnibus account corresponds to a cross-margining agreement between The OCC, the CME and the New York Clearing Corporation. The other omnibus account corresponds to a cross-margining agreement between The OCC and the Board of Trade Clearing Corporation. The OCC will compute margin for the special omnibus accounts using the same portfolio margin methodology applied at the customer level. The OCC will continue to require full payment from the clearing firm for all long option positions. However, as previously noted, long positions will not be segregated like they are in the firm's regular customer range account at The OCC. This is necessary and preferred

with a portfolio margining methodology because all long positions must be available for margin offset. Margin relief is based on a dollar offset basis as opposed to identifying specific contract to contract offsets under a strategy-based methodology. This may result in situations where the long positions of a given customer could serve to offset the risk in another customer's short position. Long positions would, therefore, be subject to The OCC lien. An OCC clearing member currently has the ability to unsegregate a long position in order to pair it with a short position (contract to contract basis) and form a qualified spread. Under the proposed treatment of long positions in a portfolio margin omnibus account at The OCC, all long positions would be unsegregated, freeing The OCC clearing member from the task of determining which long positions offset risk and from specifying each position to be unsegregated.

h. Rationale For Portfolio Margin

Portfolio margining brings a modern approach to quantifying risk and offers a number of efficiencies. It eliminates the task of analyzing the portfolio and sorting it according to currently recognized strategies (*e.g.*, spreads), and computing a margin requirement for each individual position or strategy. This process becomes quite cumbersome in an account with multiple positions and complex strategies. More importantly, for a given market move, up or down, in a diverse portfolio there will be listed option positions that appreciate and other option positions that will depreciate. Under a portfolio margin system, offsets are fully realized, whereas, under the current strategy-based system, positions and/or a group of positions comprising a single strategy are margined independent of each other and offsets between them do not figure into the total margin requirement as efficiently. In addition, under a portfolio margin system, the volatility of an individual listed option series is used in the theoretical pricing model that renders the price used to compute a gain/loss on that option position at each valuation point. This links the margin required to the risk in each particular position in contrast to the strategy-based margin. Strategy-based margin applies a universal percentage requirement (of the underlying index value) to all short option positions in the same category (*e.g.*, broad-based), irrespective of the fact that all options prices do not change equally (in percentage terms) with a change in the price or level of the underlying instrument.

Theoretical options pricing models have become widely accepted and utilized since Fischer Black and Myron Scholes first introduced a formula for calculating the value of a European style option in 1973. Other formulas, such as the Cox-Ross-Rubinstein model have since been developed. Option pricing formulas are now used routinely by option market participants to analyze and manage risk and have proven to be highly effective and preferred. In addition, essentially the same portfolio methodology described above has been used successfully by broker-dealers since 1994 to calculate haircuts on option positions for net capital purposes.²¹

The Board of Governors of the Federal Reserve System (the "Federal Reserve Board" or "FRB") in its amendments to Regulation T in 1998 permitted SROs to implement portfolio margin rules, provided they are approved by the Commission.²² 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. A portfolio margin approach can thus have a neutralizing effect on option portfolio volatility. In times of market stress, the current strategy-based margin can result in margin calls and forced liquidations, thus contributing to the selling pressure in the market. The offset ability of portfolio margining can alleviate the need for liquidations, slowing acceleration of volatility in a crisis.

More recently, the FRB encouraged the development of a portfolio margin approach in a letter to the Commission and the CFTC delegating authority to the agencies to jointly prescribe margin regulations for security futures products.²³ In that letter, the FRB wrote that it "has encouraged the development of [portfolio margin approaches] by, for example, amending its Regulation T so that portfolio margining systems approved by the Commission can be used in lieu of the strategy-based system

²¹ On March 15, 1994, the Commission issued a no-action letter allowing the implementation of a risk-based haircut pilot program. See letter from Brandon Becker, Director, Division, Commission, to Mary Bender, First Vice President, Division of Regulatory Services, CBOE, and Timothy Hinkes, Vice President, The OCC, dated March 15, 1994. The risk-based haircut program took full effect on September 1, 1997. See "Net Capital Rule," Securities Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

²² See Federal Reserve System, "Securities Credit Transactions; Borrowing by Brokers and Dealers"; Regulations G, T, U and X; Docket Nos. R-0905, R-0923 and R-0944, 63 FR 2806 (January 16, 1998).

²³ See letter from the FRB to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, Commission, dated March 6, 2001.

²⁰ The Commission anticipates that the clearing arrangements described in this section will be the subject of a separate proposed rule change filed by the OCC.

embodied in the Board's regulation." The FRB concluded that letter by writing "The Board anticipates that the creation of security future products will provide another opportunity to develop more risk sensitive, portfolio-based approaches for all securities, including security options and security futures products."

An ability to cross-margin listed index options with index futures, and options on such futures, is critical because many professional investors hedge their listed index options with futures. Although haircuts assessed on broker-dealers with respect to computing their net capital requirement recognize offsets between securities index options and index futures, current margin practice does not allow these offsets. Cross-margin benefits the financial markets and clearing system in general, not just individual investors. Cross-margin would reduce the number of forced liquidations. Currently, an option (securities) account and futures account of the same customer are viewed as separate and unrelated. In addition, currently an option account must be liquidated if the risk in the positions has increased dramatically or margin calls cannot be met, even if gains in the customer's futures account offset the losses in the options account. If the accounts can be combined (*i.e.*, cross-margined), there is little or no net change in risk and unnecessary liquidation can be avoided. The severity of a period of high volatility in the market is lessened if the number of liquidations is reduced because, for example, liquidating into a declining market exacerbates the decline. A capability to cross-margin listed index options and index futures would further alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility, particularly in times of market downturns. Various government agencies and task groups have previously advocated implementation of a cross-margin system. Those groups include the Presidential Task Force on Market Mechanics (also known as the Brady Commission)²⁴ and the Commission.²⁵

Listed index options are now at a disadvantage to economically equivalent derivative products traded on futures exchanges in terms of margin

requirements. Since 1988, index futures and options have been margined under a portfolio margin system known as SPAN. While the risks of listed index options are no greater than an equivalent position in an index future or option on the future, margin required on listed securities index options is significantly higher in many cases. Currently, listed index options margin (excluding the option premium) for a short at-the-money contract approximates 15% of the underlying index value while SPAN margin on a comparable futures index option contract is approximately 6% of the index value. When faced with such a disparity, investment managers discerningly choose futures products over listed index options for their hedging to reduce their costs. A portfolio style margin application for listed index options will reduce disparities between securities index options and futures products, thus making listed index products more competitive and more effective tools for investors.

Relief provided by a portfolio margin system is also needed so that listed index options can compete with over-the-counter derivatives, which can be margined on a good faith basis if hedged with a listed option.²⁶

2. Statutory Basis

The Exchange believes the proposed rule change, as amended, is consistent with Section 6(b) of the Act²⁷ in general, and furthers the objectives of Section 6(b)(5) of the Act²⁸ in particular, in that it is designed perfect the mechanism of a free and open market and to protect investors and the public interest. The proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency in respect of Exchange margin requirements for complex, multiple position listed index option strategies, and to offer a cross-margin capability with related index futures positions in eligible accounts.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in the furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such proposed rule change, as amended, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the 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 an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2002-03 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2002-03. 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

²⁴ See "The Brady Report," Report of the Presidential Task Force on Market Mechanisms, January 1988, p. 59 and pp. 65-66.

²⁵ See "The October 1987 Market Break: Report by the Division," Commission, February 1988, pp. 10-57. See also the interim report of the "Working Group on Financial Markets," (Department of the Treasury, CFTC, Commission and FRB), May 1988, Appendix D III A.

²⁶ See "OTC Derivatives Dealers," Securities Exchange Act Release No. 40594, (October 23, 1998), 63 FR 59362 (November 3, 1998).

²⁷ 15 U.S.C. 78f(b).

²⁸ 15 U.S.C. 78f(b)(5).

provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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 submissions should refer to File Number SR-CBOE-2002-03 and should be submitted on or before January 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁹

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04-28184 Filed 12-23-04; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50883; File No. SR-NASD-2004-027]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by NASD, Inc., Relating to Investment Company Portfolio Transactions

December 20, 2004.

I. Introduction

On February 10, 2004, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change relating to investment company portfolio transactions. On September 17, 2004, NASD filed Amendment No. 1 to the proposed rule change.³ The proposed rule change, as amended, was published for comment in the **Federal Register** on November 5, 2004.⁴ The Commission received one comment letter in response to the proposed rule change.⁵ For the reasons discussed

below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

A. Description of the Proposal

NASD Rule 2830(k) governs NASD members' execution of investment company portfolio transactions. In general, the rule prohibits NASD members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected to be received from any source, including the investment company.⁶ However, subparagraph (7)(B) of the rule allows an NASD member, subject to the requirements of best execution, to sell the shares of, or act as an underwriter for, an investment company where that investment company "follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions * * *."

NASD now proposes to strike subparagraph (k)(7)(B) from Rule 2830 and add a new subparagraph, designated (k)(2), that would prohibit NASD members from selling the shares of, or acting as underwriter for, any investment company:

if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.⁷

As NASD noted in its description of the proposed rule change, proposed new subparagraph (k)(2) "would add an objective proscription, in that the broker-dealer's intent to favor or disfavor a particular fund would not be relevant to that prohibition. The existing proscription of paragraph (k)(1), in contrast, turns upon the question of whether a broker-dealer favors or disfavors a fund based on receipt or expected receipt of brokerage commissions."⁸ The proposed prohibition would apply not only to the distribution of shares of the fund that directs portfolio transaction

commissions to the distributing broker, but also to the distribution of the shares of any other registered investment company. Further, the rule would continue to provide that an NASD member will not violate Rule 2830(k) solely because it promotes or sells the shares of an investment company that directs fund portfolio transactions to the member, so long as the member does not engage in conduct otherwise prohibited by the rule.

B. Comment Summary

The proposal was published for comment in the **Federal Register** on November 5, 2004.⁹ The SEC received one comment letter, from the Investment Company Institute ("ICI"), in response to the proposed rule change.¹⁰ The ICI expressed support for the proposed rule change, asserting that it "would complement the Commission's recent amendment to Rule 12b-1 under the Investment Company Act of 1940, which prevents funds from paying for the distribution of their shares with brokerage commissions."¹¹ The ICI stated that NASD's proposal, "coupled with the Commission's amendment to Rule 12b-1, would make it clear to both fund advisers and broker-dealers that distribution considerations have no appropriate role in the allocation of fund brokerage."¹² The ICI also supported NASD's retention of Rule 2830(k)(7)(A) (to be re-designated (8)(A)), which provides that an NASD member would not violate the rule solely because it sells shares of an investment company for which it also executes transactions, because NASD members might otherwise "be improperly discouraged from performing both execution and sales functions for a particular fund."¹³

III. Discussion and Findings

The Commission finds the proposed rule change is consistent with the Act, and in particular with Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in

²⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Patrice Gliniecki, Senior Vice President and Deputy General Counsel, NASD, to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated September 16, 2004.

⁴ Securities Exchange Act Release No. 50611 (Oct. 29, 2004), 69 FR 64609 (Nov. 5, 2004) ("Notice").

⁵ See letter to Jonathan G. Katz, Secretary, Commission from Amy B.R. Lancellotta, Senior

Counsel, Investment Company Institute, dated November 24, 2004 ("ICI letter"). The comment letter is available online at <http://www.sec.gov/rules/sro/nasd/nasd2004027.shtml>.

⁶ See NASD Rule 2830(k)(1).

⁷ See Notice 69 FR at 64609.

⁸ See Notice, 69 FR 64609, 64610 n. 5.

⁹ See note 4, *supra*.

¹⁰ See note 5, *supra*.

¹¹ ICI letter. See *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26591 (Sept. 2, 2004) 69 FR 54728 (Sept. 9, 2004) (adopting amendments to Rule 12b-1 [17 CFR 270.12b-1] under the Investment Company Act of 1940 [15 U.S.C. 80a] to prohibit investment companies from paying for the distribution of their shares with brokerage commissions).

¹² ICI letter.

¹³ *Id.*