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Summary

Portfolio Margin Rules

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KEY POINTS

- On July 14, 2005, the Securities and Exchange Commission (the "SEC" or "Commission") approved rule filings by the Chicago Board Options Exchange (the "CBOE" or "Exchange") and New York Stock Exchange that permit member organizations to compute a margin requirement for broad-based index options and related exchange traded funds of certain customers using a portfolio (risk-based) methodology.

- With the exception of a broker-dealer customer or member of a national futures exchange,[1] a customer must have or establish, and maintain, equity of not less than five million dollars across one or more accounts with the member organization in order to open a portfolio margin and/or a cross-margin account (see 4th bullet below). Member organizations may combine all accounts (including futures accounts) carried for the same customer in identical ownership name for the purpose of meeting the minimum equity requirement.

- Only the theoretical option prices supplied by The Options Clearing Corporation ("OCC") may be used by member organizations for computing gains and losses on option positions used to produce the portfolio margin requirement. The customer portfolio margin program utilizes the same framework now used by member organizations to compute risk-based capital charges (haircuts) and the data is obtained from the OCC in the same manner.

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[1] The five million dollar minimum account equity requirement does not apply to cross-margining of a member of a national futures exchange provided the member is hedging its index futures / options positions with securities index options.

- For member organizations that are also futures commission merchants ("FCM"),[2] the approved rules also provide for a separate customer cross-margin account in which broad-based index futures and options on such futures can be combined with corresponding securities index options and exchange traded funds, and for a margin requirement to be computed by applying the portfolio margin methodology.

- However, a cross-margin account must be carried as a securities account, and until such time as relief is granted by the Commodity Futures Trading Commission ("CFTC"), member organizations must comply with the customer protection requirements of both the SEC and CFTC in respect of futures and options on futures carried in a customer cross-margin account.

- Clearing members that wish to take advantage of customer portfolio margin and/or cross-margin at the clearing house level should contact The Options Clearing Corporation.

DISCUSSION

The broad-based index portfolio margin program for certain customer is codified under new Rule 12.4 – Portfolio Margin and Cross-Margin for Index Options. As defined in the rule, "portfolio" means all options of the same class grouped with their underlying instruments and related instruments. With portfolio margining, a margin requirement is set equal to the greatest loss that, theoretically, would result if a gain or loss is computed on the portfolio as a whole at set increments to the upside and downside (e.g., …-6%, -4%, -2%, +2%, +4%, +6%…) within two endpoints (e.g., -10% to +10%).

Portfolio margin treatment allows margin to be based upon the net risks of the eligible instruments in a person's account. It is a more precise and efficient margin treatment than the current strategy-based approach, and accounts with a large number of long and short positions in puts and/or calls benefit the most from portfolio margining. This is because offsets (a loss on one position being fully or partially counteracted by a gain on another position) are fully realized. Additionally, portfolio margin includes a partial offset of profit to losses between like portfolios (e.g., OEX, SPX).

Eligible Instruments

At this time only broad-based, US listed index options, index warrants and underlying instruments are eligible for the customer portfolio margin program. Underlying instruments are defined as exchange traded funds or other fund products that hold the same securities, and in the same proportion, as contained in a broad-based index on which options are listed. Stock baskets are not permitted.

[2] In addition to being an FCM, member organizations must be a clearing member of a futures clearing organization or have an affiliate that is a clearing member of a futures clearing organization. If a member organization has a customer omnibus relationship with another broker-dealer, that broker-dealer must meet the foregoing requirements.

In the case of a cross-margin account, related instruments are also eligible. Related instruments are defined as futures contracts and options on futures contracts based on the same underlying index as the broad-based (securities) index options in a portfolio.

Assumed Market Moves (Up and Down)

For high capitalization, broad-based index portfolios, the portfolio margin requirement will be determined by computing gain or loss on positions within a range of –8% to +6% of the current index level. For non-high capitalization broad-based index portfolios, the range is –10% to +10% of the current index level. Offsets between portfolios will be the same as permitted for the purpose of risk-based capital charges (haircuts).

Eligible Participants

In order to open a portfolio margin account, a customer must have or establish, and maintain, a total equity of not less than five million dollars, and all accounts carried by the member organization in identical ownership name may be considered for the purpose of this minimum. The only exceptions to this requirement are for broker-dealer customers and members of a national futures exchange provided the member is hedging its index futures / options positions with securities index options (cross-margining).

Opening of Portfolio Margin Accounts

In order to open a portfolio margin account, a customer must be approved for options transactions pursuant to Rule 9.7, and be specifically approved in accordance with Rule 9.7(f) to engage in uncovered short option contracts.

On or before the date of an initial transaction in a portfolio margin account, customers must be provided with a special written disclosure statement describing the nature and risks of portfolio margining and cross-margining. Also, on or before the date of an initial transaction, a signed acknowledgement form must be obtained from the account owner(s) attesting that the disclosure statement has been read and understood. If a cross-margin account is opened, there is a separate acknowledgement form that must also be obtained.

Exchange Rule 9.15(c) sets forth the required format of the special risk disclosure statement and acknowledgement forms.

Set-Up of Accounts

Portfolio margining must be conducted in a dedicated securities margin account that is clearly identified as portfolio margin account. The portfolio margin account may be a sub-account of a regular margin account.

Cross-margining must be conducted in a portfolio margin account that is separate from any other portfolio margin account. This account must be clearly identified as a cross-margin account. The cross-margin account may be a sub-account of a regular margin account.

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.

Eligible Positions

Transactions in, or transfers of, listed, broad-based index options or index warrants may be effected in a portfolio margin account.

Transactions in, or transfers of, underlying instruments (e.g., an exchange traded fund) are not permitted in a portfolio margin account unless held in conjunction with offsetting broad-based index options. If a hedged underlying instrument position in a portfolio margin account becomes unhedged, and is not rehedged within 10 business days of becoming unhedged, the underlying instrument position must be transferred to a regular margin account and Regulation T initial margin imposed.

Similarly, related instruments (e.g., index futures and options on index futures) are not permitted in a cross-margin account unless held in conjunction with offsetting broad-based (securities) index options and/or underlying instruments. If a hedged related instrument position in a cross-margin account becomes unhedged, and is not rehedged within 10 business days of becoming unhedged, the related instrument position must be transferred to a futures account.

If an underlying instrument position in a cross-margin account becomes unhedged, and is not rehedged with 10 business days of becoming unhedged, the underlying instrument position must be transferred to a regular margin account and Regulation T initial margin imposed.

Member organizations are expected to monitor portfolio margin accounts for possible abuse of these provisions.

All of a clearing firm's customer long positions in a portfolio margin or cross-margin account are held for the firm at the Options Clearing Corporation in a bulk customer portfolio margin or cross-margin lien account, respectively. The OCC will continue to collect full payment for long positions from clearing firms. However, all long positions in the firm's bulk customer portfolio margin and cross-margin account will automatically be subject to an OCC lien. SEC customer protection rules generally prohibit a third party from holding a security interest in a fully paid for security. Therefore, Rule 12.4 requires that, in the event that fully paid for long option positions are all that exist in either a portfolio margin or cross-margin account, such positions must be transferred to a

regular securities margin or cash account within 10 business days of reaching such status. Margin account positions are subject to the Exchange's strategy-based maintenance margin requirements. If prior to the end of the 10 day time limit, the status of the account changes such that it is no longer composed solely of fully paid for long positions, no action is necessary.

Portfolio Margin Requirement

Under the portfolio margin methodlogy, a gain or loss on each position will be computed at five equi-distant data points to the downside[3] and five equi-distant data points to the upside[4]. Only the theoretical option prices supplied by the OCC may be used to compute gains and losses. The results for all positions will be totaled at each data point and the data point total that has the greatest loss will be the margin requirement for that portfolio. The margin requirements for all portfolios are derived by the same method. Any offsets allowed between portfolios (e.g. OEX vs. SPX) pursuant to the risk-based method for computing haircuts under the net capital rule are then applied. All portfolio margin requirements are then added together to arrive at the total margin requirement for an account. The portfolio margin requirement is both an initial and maintenance margin requirement. Guarantees by any other account for purposes of margin requirements are not permitted.

There will be a minimum margin requirement of $.375 for each listed option contract 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.

Minimum Equity

As previously noted, a customer must have equity of not less than five million dollars in total across one or more accounts with the member organization to open a portfolio margin or cross-margin account.[5] In the event equity falls below five million dollars for three consecutive business days, member organizations may not effect new opening orders in a portfolio margin or cross-margin account beginning on the fourth business day, except for opening orders that hedge existing positions and would lower the margin requirement. Upon restoration of account equity of five million dollars, opening orders of any type may again be accepted. A separate, additional five million dollar equity is not required to have a portfolio margin account and a cross-margin account.

Valuing Positions for Margin Purposes

All listed index options and related instruments are to be valued at current market prices.

[3] Down to –10% for a non-high capitalization index, –8% for a high capitalization index.
[4] Up to +10% for a non-high capitalization index, +6% for a high capitalization index.
[5] Member organizations may combine all accounts (including futures accounts) carried for the same customer in identical ownership name for the purpose of meeting the minimum equity requirement.

Computation of Account Equity

Equity for purposes of a portfolio margin account 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.

As noted above, if the equity in a portfolio margin or cross-margin account is below the required level of margin, the deficit may not be considered as satisfied by any excess equity in the other account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained.

Margin Deficiency

If at any time, the equity in a portfolio margin or cross-margin account is less than the margin required, the member organization must obtain sufficient margin to cover the deficit within one business day (T+1). In the event margin is not obtained within one business day, the member organization must lower the total margin requirements to an amount that does not exceed equity by liquidating positions. Exchange Rule 12.9 – Meeting Margin Calls by Liquidation, does not apply to liquidations in a portfolio margin or cross-margin account. However, under Rule 12.4, member organizations are expected to monitor the risk of portfolio margin and cross-margin accounts. Accounts with a pattern or practice of establishing positions and liquidating without depositing margin is a risk and something that should be addressed in written procedures (see “Risk Monitoring Procedures” below).

Day Trading

Day trading margin requirements [Exchange Rule 12.3(j)] do not apply to portfolio margin and cross-margin accounts.

Requirement to Liquidate Cross-Margin Accounts

In the event that a member organization carrying cross-margin accounts becomes insolvent, futures and options on futures in cross-margin accounts are required under Rule 12.4 to be liquidated, or transferred out. In this way, futures / options on futures will be deemed liquidated to cash upon insolvency, and cash is eligible for SIPC coverage.

Therefore, pursuant to Rule 12.4, member organizations are required immediately to either liquidate or transfer to another broker-dealer able to carry cross-margin accounts, all customer cross-margin accounts that contain positions in futures and/or options on futures if the member organization is:

- insolvent as defined in section 101 of title 11 of the United States Code or is unable to meet its obligations as they mature;
- 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;
- 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
- unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

Net Capital

Pursuant to new Exchange Rule 13.5 – Customer Portfolio Margin Accounts, member organizations must limit gross customer portfolio margin requirements, including margin required in cross-margin accounts, to not more than 10 times net capital.

If, at any time, a member organization's gross customer portfolio margin requirements exceed 10 times its net capital, the member organization must immediately send telegraphic or facsimile notice to SEC's headquarters in Washington, DC; to the SEC's district or regional office and to the member organization's Designated Examining Authority.

Furthermore, if a member organization's gross customer portfolio margin requirements exceed 10 times its net capital for three consecutive business days, the member organization is prohibited from opening any new portfolio margin or cross-margin accounts beginning on the following (4th) business day. If and when compliance is reestablished, new accounts may again be opened.

Risk Monitoring Requirements

Pursuant to new Exchange Rule 15.8A – Risk Analysis of Portfolio Margin Accounts, member organizations must establish and maintain written procedures for assessing and monitoring the potential risk to the member organization's capital in connection with its customer portfolio margin and cross-margin accounts.

Member organizations are required to file their procedures, as well as any subsequent replacements or revisions, with the Exchange's Department of Member Firm Regulation.

Rule 15.8A contains minimum standards that a member organization's written procedures must meet. Additionally, written procedures for assessing and monitoring the potential risk of portfolio margin accounts must meet the standards outlined in the

Interpretations and Policies to Exchange Rule 15.8 – Risk Analysis of Market-Maker Accounts.

Rule References

The new Exchange rules related to portfolio margining that are now in effect are listed below and can be found through the website page www.cboe.org/Legal/:

- 12.4 – Portfolio Margin and Cross-Margin for Index Options;
- 9.15(c) (concerning the Portfolio Margining and Cross-Margining Disclosure Statement and Acknowledgement form);
- 13.5 – Customer Portfolio Margin Accounts (concerning limit on gross customer portfolio margin requirements in relation to net capital); and
- 15.8A - Risk Analysis of Portfolio Margin Accounts and 15.8 – Risk Analysis of Market-Maker Accounts.

Questions concerning the portfolio margin and cross-margin rules should be directed to James Adams at (312) 786–7718.

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