SEC APPROVES AMENDMENTS TO NYSE AND CBOE MARGIN RULES THAT SUBSTANTIALLY EXPAND PORTFOLIO MARGINING

Washington, DC
January 3, 2007

On December 12, 2006, the Securities and Exchange Commission (the "SEC") approved amendments to the margin rules of the New York Stock Exchange, LLC (the "NYSE") and the Chicago Board Options Exchange, Incorporated (the "CBOE") that substantially expand the ability of member firms to establish customer margin requirements using a risk-based portfolio margining methodology.[1] The amendments will be effective on April 2, 2007. Comments on the amendments (parts of which were approved on an accelerated basis) may be filed with the SEC by January 8, 2007.

With these amendments, the NYSE and CBOE portfolio margining pilot programs will cover individual equity securities, listed and unlisted equity-based derivatives (including over-the-counter ("OTC") options, swaps and forwards), security futures and certain related futures positions. The amendments are the culmination of years of effort by regulators and industry participants to establish a portfolio-margining framework in lieu of the specific margin percentages that currently apply to individual securities positions. It is anticipated that the amendments will result in substantially lower initial and maintenance margin requirements for qualifying customer portfolios, particularly those that include hedging or other risk reducing positions that are currently margined on a cumulative basis.

This memorandum provides a detailed summary of the NYSE's revised pilot program (the "Revised Pilot").[2] A table of contents is set forth on the following page.

---

1 SEC Release No. 34-54918 (Dec. 12, 2006), 71 Fed. Reg. 75790 (Dec. 18, 2006) (the "Approval Release"); SEC Release No. 34-54919 (Dec. 12, 2006), 71 Fed. Reg. 75781 (Dec. 18, 2006). See also NYSE Information Memo 06-86 (Dec. 21, 2006) ("IM 06-86"); CBOE Regulatory Circular RG06-128 (Dec. 15, 2006).

2 The CBOE's amended pilot program is substantially similar to the NYSE's Revised Pilot.

TABLE OF CONTENTS

* * * * *

I. Summary of Key Considerations.

- **Reduction in Margin Requirements Under Revised Pilot.** The Revised Pilot's risk-based margining regime – covering a range of products and recognizing offsets between related instruments – reflects a significant modification to current margin rules and may result in substantially reduced margin requirements for many customers.[3] The extent to which the Revised Pilot will result in major changes in the way U.S. broker-dealers conduct their equity finance business – and particularly whether it will create sufficient incentives for large prime brokerage firms to provide more financing directly to customers rather than arranging such financing through foreign broker-dealer affiliates not subject to U.S. broker-dealer margin and capital requirements – remains an open question. Several practical considerations that may have a bearing on this question are noted below.

- **Need for Certain Regulatory Filings and Approvals.** A firm must make certain filings with, and receive certain approvals from, the NYSE and the SEC in order to implement the Revised Pilot. The required filings include a written risk analysis methodology and procedures that must address an extensive range of topics specified by the NYSE. The effective date of the Revised Pilot was delayed until April 2, 2007, to provide regulators with time to review applications, but **the NYSE has stated that member firms should submit such applications by February 15, 2007,** to be eligible for approval by April 2, 2007. (Part III.A below).

---

3 The Approval Release states that the Revised Pilot, "in most cases, will generally lower customer margin requirements," and further notes: "For example, the current required initial and maintenance margin requirements for an equity security are 50% and 25%, respectively. The market movement range to calculate the potential gains and losses under the proposed portfolio margin rule for equity securities is +/- 15%." Approval Release at 75791, n. 15.

- **Portfolio Margining Methodology.** The Revised Pilot prescribes a certain methodology to determine the risk associated with a customer's portfolio for margin purposes. Some firms may find this methodology less comprehensive or flexible (e.g., with respect to pricing models, recognized offsets, the scope of products covered, etc.) than methodologies they currently use for their own risk management purposes or to establish customer margin requirements in non-U.S. jurisdictions. The NYSE has indicated it may be possible to use proprietary methodologies as alternatives in the future, but for now firms must use the methodology set forth in the Revised Pilot. (Part III.E.1 below).

- **Use of Proprietary Theoretical Pricing Models.** A key element of the portfolio margining methodology under the Revised Pilot is the use of an SEC-approved theoretical pricing model to determine potential gains or losses in a customer's portfolio. Currently, the Options Clearing Corporation's (the "OCC's") Theoretical Intermarket Margining System ("TIMS") is the only model that has been so approved. Concerns have been raised about whether firms will be able to use TIMS for unlisted derivatives. The SEC staff has indicated informally that in the context of unlisted derivatives they are willing to review and approve proprietary pricing models for determining theoretical gains and losses. The procedures and standards to be followed in connection with these approvals have not been specified. Firms that may wish to obtain approvals for their own pricing models for unlisted derivatives should contact the SEC and NYSE staff promptly. (Part III.E.3 below).

- **Capital Charges for Unlisted Derivatives.** Even if a firm receives SEC approval for a proprietary pricing model for purposes of unlisted derivatives, the SEC's net capital rule (Rule 15c3-1) generally imposes significant capital charges on such transactions. For many firms, these capital charges may limit the desirability of conducting such transactions in a registered broker-dealer, notwithstanding any reduction in the margin requirement for such transactions under the Revised Pilot.

- **Potential Advantages for CSE Firms.** Broker-dealers subject to the SEC's net capital framework for consolidated supervised entities ("CSE broker-dealers") may have several advantages in terms of effecting transactions in unlisted derivatives under the Revised Pilot.[4] First, the capital charges associated with unlisted

[4] In 2004, the SEC established a voluntary, alternative method of computing net capital for CSE broker-dealers that permits them to calculate deductions to net capital for market and credit risk for qualifying positions using proprietary models, including internally developed "value-at-risk" models

(continued. . .)

derivatives are generally lower for CSE broker-dealers. Second, CSE broker-dealers already have experience with obtaining SEC approval for their proprietary risk models. Although these approvals involved value-at-risk models used for capital purposes, this previous experience may facilitate applications by CSE broker-dealers to use proprietary pricing models to price unlisted derivatives under the Revised Pilot.[5]

- **"Per Contract Minimum" Margin Requirement.** The Revised Pilot includes a "per contract minimum" margin requirement ($0.375 multiplied by the contract's "multiplier") that applies even if the greatest theoretical loss determined pursuant to the portfolio margining methodology is *de minimis*. (Part III.E.2 below).

- **Cross-Margining.** Although the Revised Pilot contemplates "cross-margining" between securities and futures positions (referred to under the Revised Pilot as "related instruments"), the inclusion of futures in a portfolio margin account appears to be contingent on the resolution of certain regulatory issues associated with carrying both securities and futures in a securities account. (Part IV.A below).

(. . . continued)

and scenario analysis, rather than the traditional haircut approach for computing net capital under Rule 15c3-1. See Exchange Act Release No. 49830 (June 8, 2004), 69 Fed. Reg. 34427 (June 21, 2004). For more discussion of the CSE Net Capital Amendments, see Cleary Gottlieb, SEC Adopts Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, July 28, 2004, available at http://www.cgsh.com/english/news/alertdetail.aspx?id=192.

5 The same may be true for firms that have established an OTC derivatives dealer (i.e., a so-called "BD Lite" entity) under SEC Rule 15a-1.

II. **Background**.

A. Portfolio/Risk-Based Margining. Traditionally, NYSE Rule 431 has specified fixed margin percentage requirements applicable to individual securities positions. This approach has not fully recognized hedges or other risk offsets between different positions that may reduce the overall risk of a portfolio.[6] In addition, the fixed margin percentages established for each position have not taken into account the fact that the prices of different security positions (e.g., options) related to the same underlying instrument do not necessarily change equally (in percentage terms) in relation to a change in the price of the underlying instrument.

Under the Revised Pilot, margin levels are assessed based on the risk of a portfolio of positions related to the same underlier, taken as a whole, so that offsets between positions within that portfolio can be recognized. The Revised Pilot uses a theoretical pricing model to measure the potential gains and losses to each position in the portfolio under multiple pricing scenarios. Subject to a "per contract minimum" requirement established under the Revised Pilot, the margin required for each portfolio is determined by reference to the greatest theoretical loss incurred by the portfolio in aggregate after "shocking" the portfolio for upward and downward price movements within a defined range above and below the current market price (e.g., +/- 10%) of the instrument or (in the case of a derivative) its underlier.

In the Approval Release, the SEC notes that the Revised Pilot, which is based generally on the methodology used by broker-dealers to calculate net capital haircuts for certain options and related positions for purposes of SEC Rule 15c3-1,[7] "may better align a customer's total margin requirement with the actual risk associated with the customer's positions taken as a whole," and "may alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility."[8]

---

[6] In limited circumstances, Rule 431 recognizes certain strategies involving multiple positions (particularly options positions) and imposes a specified margin requirement on such strategies as a whole. This memorandum uses the term "position-based margin requirements" to refer to the Rule 431 requirements applicable to either individual securities positions or strategies maintained in a traditional margin account.

[7] See Rule 15c3-1a and SEC Release No. 34-38248 (Feb. 6, 1997), 62 Fed. Reg. 6474 (Feb. 12, 1997).

[8] Approval Release at 75793.

B. Regulatory Background.

1. Portfolio Margining Under Regulation T. Regulation T of the Board of Governors of the Federal Reserve System (the "Board") generally establishes initial margin requirements for securities-related credit transactions. In 1998, the Board opened the way for portfolio margining by amending Regulation T to exclude from its scope any financial relations between a customer and a broker-dealer that comply with a portfolio margining regime approved by the SEC.[9]

2. Previous Rule 431 Portfolio Margining Pilot Programs. The Revised Pilot is the third iteration of the NYSE's portfolio margining pilot program. The first version was approved by the SEC on July 14, 2005, for listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds.[10] Subsequently, in response to calls for an expansion to this pilot program,[11] on December 29, 2005, the NYSE filed proposed amendments (sometimes referred to as the "Track I" amendments) to include security futures and listed single stock options.[12] The SEC approved the Track I amendments on July 11, 2006.[13]

---

9 See Regulation T, Section 220.1(b)(3)(i). The Board also encouraged the development of portfolio margining when it delegated authority to set margin requirements for security futures to the SEC and the Commodity Futures Trading Commission (the "CFTC"). Letter from the Board to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC, dated March 6, 2001. See also SEC Rule 400(c)(2)(i) (exempting from the security futures margin requirements financial relations between a customer and a security futures intermediary that comply with an appropriate portfolio margining system); CFTC Rule 41.42(c)(2) (comparable exemption).

10 See SEC Release No. 34-52031 (July 14, 2005), 70 Fed. Reg. 42130 (July 21, 2005) (approving SR-NYSE-2002-19). See also NYSE Information Memo 05-56 (Aug. 18, 2005) and SEC Release No. 34-52032 (July 14, 2005), 70 Fed. Reg. 42118 (July 21, 2006) (approving SR-CBOE-2002-03).

11 See Letter from SEC Chairman Christopher Cox to William J. Brodsky and John A. Thain, the Chief Executive Officers of the CBOE and NYSE respectively, dated Sept. 27, 2005 (encouraging the exchanges to file rule amendments by the end of 2005 expanding portfolio margining to other equity products, including single stock options and security futures). In addition, two bills introduced in Congress in 2005 also had the effect of encouraging the expansion of the portfolio margining pilots. See The Commodity Exchange Reauthorization Act of 2005 (S. 1566), and The CFTC Reauthorization Act of 2005 (H.R. 4473).

12 See SEC Release No. 34-53126 (Jan. 13, 2006), 71 Fed. Reg. 3586 (Jan. 23, 2006). On December 29, 2005, the CBOE filed a similar expansion to its pilot program with the SEC (SR-CBOE-2005-118). That proposal was incorporated into a subsequent CBOE filing, which the SEC published for

(continued. . .)

Separately, the NYSE proposed the current amendments (sometimes referred to as the "Track II" amendments), which were published by the SEC for comment on March 30, 2006,[14] and amended by the NYSE on September 13, 2006. The "Track II" amendments were approved on December 12, 2006. The expiration date of the pilot program remains July 31, 2007, the date established when the pilot was first approved in 2005. The NYSE has indicated, however, that it plans to submit a rule amendment to the SEC that will make the pilot permanent.[15]

3. Comparison of Revised Pilot and Previous Pilot. Some of the key differences between the Revised Pilot and the previous version of the NYSE's Rule 431 portfolio margining pilot program (Track I) can be summarized as follows:

	PREVIOUS PILOT PROGRAM	**REVISED PILOT**
ELIGIBLE PRODUCTS	Listed broad-based securities index options, warrants, futures, futures options, and related exchange-traded funds; security futures (other than those on narrow-based indices); and listed single stock options.	In addition to previously eligible products, individual margin equity securities (including certain control/restricted stock), unlisted derivatives based on equities and security futures on narrow-based indices.
ELIGIBLE PARTICIPANTS	Must have $5 million in equity if not a broker-dealer or futures commission merchant ("FCM") (unless account is limited to listed single stock options and security futures).	$5 million in equity required only if the customer (i) is not a registered broker-dealer or FCM and (ii) transacts in unlisted derivatives.

(. . . continued)
comment on March 30, 2006. See SEC Release No. 34-53576 (Mar. 30, 2006), 71 Fed. Reg. 17519 (Apr. 6, 2006).

13 See SEC Release No. 34-54125 (July 11, 2006), 71 Fed. Reg. 40766 (July 18, 2006). See also NYSE Information Memo 06-57 (Aug. 2, 2006).

14 See SEC Release No. 34-53577 (Mar. 30, 2006), 71 Fed. Reg. 17539 (Apr. 6, 2006).

15 IM 06-86, n.3.

	PREVIOUS PILOT PROGRAM	**REVISED PILOT**
ACCOUNT STRUCTURE	Two accounts: a *portfolio margin account* for portfolios that include only securities and a *cross-margin account* for portfolios that include futures.	Single portfolio margin account, which is a securities account, used for all positions. Separate cross-margin account eliminated.
PERMITTED COLLATERAL	Accounts may only hold products eligible for portfolio margining.	Non-equity securities and money market funds can be held in portfolio margin account as collateral if margined under traditional, position-based margin requirements.
RISK ANALYSIS METHODOLOGY	Must be provided to NYSE upon request.	Expanded requirements; must be filed with NYSE and SEC before engaging in portfolio margining.
DAY TRADING	Day trading permitted.	Day trading permitted if positions are part of a hedge strategy or if account maintains $5 million in equity and firm monitors intra-day risk.
UNHEDGED POSITIONS	"Underlying instrument" must be removed from account in 10 business days if no longer part of a hedge strategy.	No explicit requirement to remove an "underlying instrument" that is not part of a hedge strategy. See Part III.D.2 below.

III. <u>Detailed Summary of Revised Pilot</u>.

A. <u>Prerequisites to Offering Portfolio Margining</u>. The Revised Pilot establishes certain prerequisites to offering a portfolio margin account to any customers.

1. NYSE Approval. A member must notify and receive approval from the NYSE (or, if different, its designated examining authority ("DEA")) prior to implementing the Revised Pilot's portfolio margining methodology for any customer. (Rule 431(g)(5)(A)). To address competitive disadvantages that might arise if some firms were to receive regulatory approvals before others, the SEC approved a delayed effective date for the Revised Pilot of April 2, 2007, to provide additional time to process requests to offer portfolio margining.[16]

---

16 Approval Release at 75794.

IM 06-86 provides some guidance regarding the NYSE approval process. Importantly, it states that firms should submit their applications to the NYSE by February 15, 2007, in order to be eligible for approval by April 2, 2007. In addition, IM 06-86 specifies certain supporting documentation that must accompany the application, including compliance and supervisory procedures that address the topics described in the next two sections below. The application should be submitted to the firm's finance coordinator.[17]

2. Written Risk Analysis Methodology. A member must establish a comprehensive written risk analysis methodology for assessing the potential risk to the member's capital over a specified range of possible market movements with respect to positions in portfolio margin accounts. The methodology must specify the computations to be made, the frequency of the computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. The methodology must be filed with the NYSE (or, if different, its DEA) and submitted to the SEC, prior to implementing portfolio margining. (Rule 431(g)(1)).

The Revised Pilot specifies a number of procedures and guidelines that must be included in the written risk analysis methodology. These include:

(i) Obtaining and reviewing the appropriate account documentation and financial information necessary for assessing the amount of credit to be extended to eligible participants;

(ii) The determination, review and approval of credit limits for each eligible participant, and across all eligible participants, utilizing a portfolio margin account;[18]

---

17 The application also must include an organization chart identifying those persons primarily responsible for portfolio margin risk management and the persons to whom they report.

18 In responding to comments on the proposed version of the Revised Pilot, the NYSE stated that "member organizations are not required to impose specific credit limits as a matter of policy, but rather determine the credit profile of each customer, and if the member organization believes that it is necessary to impose a credit limit, to ensure that procedures promulgated [under the risk analysis methodology] are adhered to." See Letter from Mary Yeager, Assistant Secretary, NYSE, to Michael Macchiaroli, Associate Director, Division of Market Regulation, SEC (July 20, 2006).

(iii) Monitoring credit risk exposure to the member firm from portfolio margin accounts, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management;

(iv) The use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate;

(v) The regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group;

(vi) Managing the impact of credit extended related to portfolio margin accounts on the member firm's overall risk exposure;

(vii) The appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded; and

(viii) Determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product. (Rule 431(g)(1)(A)-(H)).

The Revised Pilot further requires that management (i) periodically review, in accordance with written procedures, the member firm's credit extension activities for consistency with these guidelines, and (ii) periodically determine if the data necessary to apply the Revised Pilot is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data. (Rule 431(g)(1)).

3. Procedures Required by IM 06-86. In IM 06-86, the NYSE provides an additional list of specific topics that must be addressed by a firm's written procedures, which overlap to some extent with those specified by Rule 431(g)(1). These topics include:[19]

(i) Account opening procedures, including the profile of customers who will be eligible for portfolio margining and the initial approval process to be applied;

[19] IM 06-86 should be consulted for the complete list of topics specified by the NYSE.

(ii) A description of any internal model used to determine risk in a customer's account, documentation for this model, a description of correlation assumptions used in models for assessing the adequacy of margin in a customer's account, and a description of stress testing scenarios to be performed, their frequency, and the results of the most recent stress test;

(iii) Monitoring of accounts to ensure that the account contains a portfolio of hedged instruments;[20]

(iv) Identification of security concentrations within an account, and concentrations in individual securities across customer accounts;

(v) Detection and prevention of any circumvention of day trading requirements;[21]

(vi) Monitoring the limitation on credit extended on portfolio margining to 1,000 percent of the member's net capital;[22] and

(vii) A description of the process for obtaining the TIMS theoretical valuation points, of the process used to compute margin requirements in customer accounts, and of house margin requirements if they differ from the TIMS requirement.

IM 06-86 also states that if a member seeks to provide portfolio margining with respect to unlisted derivatives, the application should include a description of the products as well as a detailed description of the credit analysis and collateral management process that will be utilized to monitor any exposure that may result to the member. This information may be submitted at a later date if unlisted derivatives are not included in the initial portfolio margining account offered to customers.

---

20 See Part III.D.2 below.

21 See Part III.H below.

22 See Part III.G below.

B. Eligible Participants.

1. Permitted Customer Types. For purposes of the Revised Pilot, "eligible participants" are:

(i) Broker-dealers registered with the SEC pursuant to Exchange Act Section 15;

(ii) Members of a national futures exchange, to the extent that listed index options hedge their index futures; and

(iii) Any other person or entity not listed above that has been approved to trade uncovered options (and security futures, if these are to be included in the account).[23] (Rule 431(g)(4)).

Portfolio margin accounts may not be established for individual retirement accounts. (Rule 431(g)).

2. Minimum Equity Requirements for Certain Participants. Eligible participants that are not registered broker-dealers or members of a national futures exchange may not establish or maintain positions in unlisted derivatives unless they establish and maintain a minimum equity of $5 million. All securities and futures accounts carried by the member for the eligible participant may be combined for purposes of satisfying this minimum equity requirement, provided that ownership across the accounts is identical. A guarantee under NYSE Rule 431(f)(4) does not qualify for purposes of meeting this minimum equity requirement. (Rule 431(g)(4)(C)).

If the equity in the portfolio margin account declines below the $5 million minimum requirement, and is not restored to at least that level within three business days by a deposit of funds and/or securities, the member is prohibited from accepting new opening orders beginning on the fourth business day (except that new opening orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements). This prohibition remains in effect until (i) equity of $5 million is established,

---

23 The requirement that the person or entity be approved to trade uncovered options apparently applies whether or not such person writes uncovered options. NYSE Rule 431(g)(5)(B) further states that "[o]nly eligible participants that have been approved to engage in uncovered short option contracts pursuant to [NYSE] Rule 721, or the rules of the member organization's DEA, if other than the [NYSE], are permitted to utilize a portfolio margin account." It is not clear, however, whether this requirement is intended to apply to eligible participants that are registered broker-dealers.

or (ii) all unlisted derivatives are liquidated or transferred out of the portfolio margin account and into an appropriate securities account. Members do not have the option of deducting the amount of any minimum equity deficiency from their net capital in lieu of collecting the required minimum equity. (Rule 431(g)(9)).

C. Establishment of a Portfolio Margin Account.

1. Need for a Separate Portfolio Margin Account. In establishing a portfolio margin account for an eligible participant, members are required to use a specific securities margin account, or a sub-account of a margin account, that is clearly identified as a "portfolio margin account" and that is separate from any other securities account carried for the eligible participant. (Rule 431(g)(6)(A)).

2. Elimination of Cross-Margin Account. Significantly, the Revised Pilot eliminates the requirement under the previous version of the pilot program that a firm establish a separate "cross-margin" account for portfolios that include futures positions. Various implications of this new "single-account" approach to cross-margining, as well as alternative approaches, were addressed in comments submitted on the Revised Pilot, as discussed more fully in Part IV.A below.

A member firm must liquidate all portfolio margin accounts (or transfer them to another broker-dealer eligible to carry portfolio margin accounts) if the account has futures positions and the member experiences certain potential credit-related events – such as being insolvent, subject to bankruptcy proceedings, and/or not in compliance with financial responsibility requirements. (Rule 431(g)(14)).

3. Delivery of Risk Disclosure Statement; Other Options Rules. Prior to permitting any transactions in a portfolio margin account, a member must give the eligible participant a special written disclosure statement that describes the nature and risks of portfolio margining. The eligible participant must sign a statement acknowledging that it has read and understood the disclosure statement and agrees to the terms of the account. The member firm must obtain this signed acknowledgement and record the date of receipt. (Rule 431(g)(5)(C)).

Although under earlier versions of the pilot program the NYSE had included in Rule 726 a form of this disclosure statement, no such form was included in the Revised Pilot. Instead, to avoid having to file a proposed rule change each time the risk disclosure document is modified, the NYSE will provide a sample disclosure statement in an Information Memo.[24] It is expected that the disclosure document under the Revised Pilot will be substantially similar to that used under earlier versions of the pilot, although modifications may be made to the manner in which the document addresses certain issues, discussed more fully in Part IV.A below, associated with carrying futures positions in a securities margin account.

The Revised Pilot also requires a member firm to "ensure that portfolio margin accounts are in compliance with all other applicable [NYSE] rules promulgated in Rules 700 through 795" – i.e., the NYSE's "Options Rules." (Rule 431(g)(15)).

D. Products Eligible for Portfolio Margining.

1. Eligible Products. Products eligible for portfolio margining treatment are:

(i) Margin equity securities within the meaning of the Board's Regulation T,[25] which include:

- Equity securities listed on a U.S. securities exchange or NASDAQ, and
- Foreign equity securities and options on foreign equity securities, provided the security is deemed to have a "ready market" under SEC Rule 15c3-1 or an SEC no-action letter thereunder.[26]

Control or restricted securities may qualify as eligible products for these purposes if they satisfy the requirements (in a manner consistent with SEC Rule 144 or an SEC no-action letter thereunder) to permit their sale upon exercise or assignment of any listed option or unlisted derivative written or held against such securities, without restriction;

---

[24] Approval Release at 75792, n.27.

[25] See Regulation T, Section 220.2.

[26] "Margin equity security" under Regulation T also includes debt that is convertible into a margin equity security. The Revised Pilot does not specify what conditions may apply to convertible debt (e.g., whether it must be capable of conversion within a certain period of time, how to handle conversion costs, etc.).

(ii) Listed options on an equity security or index of equity securities;

(iii) Security futures;

(iv) "Unlisted derivatives," meaning under Rule 431(g)(2)(I) any equity-based or equity index-based unlisted option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the SEC;[27]

(v) A warrant on an equity security or index of equity securities; and

(vi) "Related instruments," meaning under Rule 431(g)(2)(E), within a security class or product group, broad-based index futures and options on broad-based index futures covering the same underlying instrument.[28]

All other financial instruments and products are ineligible for portfolio margining. In particular, the NYSE did not accept comments suggesting that it expand the Revised Pilot to include non-equity securities, interest rate derivatives, collateralized debt obligations and other similar non-equity products, and foreign currency derivatives. The NYSE indicated that it would consider including non-equity securities in the future once it has more experience with portfolio margining.[29]

---

[27] Under a separate NYSE rule proposal published for comment by the SEC on July 31, 2006, a new paragraph (e)(9) would be added to Rule 431 to exempt certain CSE broker-dealers from any margin requirements on certain OTC derivative instruments. See SEC Release No. 34-54255 (July 31, 2006), 71 Fed. Reg. 45086 (Aug. 8, 2006). If adopted, this proposal would provide greater flexibility for CSE broker-dealers to conduct unlisted derivatives even outside the context of a portfolio margin account. In light of the adoption of the Revised Pilot, however, the status of this proposal is uncertain.

[28] The introductory language to Rule 431(g) indicates that a member firm that is an FCM and that either is a clearing member of a futures clearing organization or has an affiliate that is a clearing member, is permitted to combine an eligible participant's "related instruments" with "listed index options, options on exchange-traded funds ("ETF"), index warrants and underlying instruments." Although this list does not appear to contemplate the combination of unlisted derivatives (e.g., an OTC option or swap on an index) and "related instruments" in the same portfolio, it is not clear whether such combinations were intended to be prohibited by the Revised Pilot.

[29] Approval Release at 75793. See Part III.F.4 below (regarding the use of non-equity securities as collateral in a portfolio margin account).

2. Unhedged Positions. Under earlier versions of the pilot program, a position in an underlying instrument (e.g., an ETF) could be established in a portfolio margin account only in conjunction with a position in an offsetting derivative. In addition, if the underlying instrument were no longer part of a "hedge strategy," it would need to be removed from the account within ten business days. In the Revised Pilot, the NYSE eliminated these requirements, noting it had received comments that all eligible products, "including underlying securities, should receive equal treatment" and that it would be operationally difficult to move positions in and out of a portfolio margin account based on whether they are currently offset.[30]

The elimination of the requirement that "underlying instruments" be part of a "hedge strategy," together with the expansion of eligible products to include individual equities, appear to permit unhedged positions in a single stock to be established or maintained in a portfolio margining account indefinitely and treated as eligible for the portfolio margining provisions of the Revised Pilot. The NYSE has indicated, however, that firms must establish procedures for "monitoring of accounts to ensure that the account contains a portfolio of hedged instruments."[31] Accordingly, although the NYSE clearly intended to provide greater flexibility to include unhedged positions in a portfolio margin account, it may have anticipated that this would occur in the context of a trading strategy that normally would give rise to a "portfolio of hedged instruments." It is not clear, however, what constitutes a "portfolio of hedged instruments" for these purposes and how long unhedged positions can remain in the account.

E. Calculation of Portfolio Margin Requirements.

1. Methodology for Calculations. The calculation of the margin requirement for the portfolio margin account can be broken down into the following steps.[32]

---

30 Approval Release at 75792.

31 See IM 06-86, p.4.

32 As noted above, this methodology is generally based on the methodology for determining a broker-dealer's net capital deductions for certain options positions. See Appendix A of Rule 15c3-1. The Approval Release stated that the Revised Pilot "will serve to advance the development of even more risk sensitive approaches to margining customer positions, including the use of internal models as advocated by commenters. The Commission intends to work with the NYSE and the CBOE towards this objective after it gains experience with the portfolio margining system of this proposal." Approval Release at 75793.

First, all positions (long and short) in eligible products, including underlying instruments and futures, are grouped by "security class" – i.e., all listed options, security futures products, unlisted derivatives, and related instruments covering the same underlying instrument and the underlying instrument itself. (Rule 431(g)(2)(F)). This grouping is referred to as a "portfolio." (Rule 431(g)(2)(C)). For example, futures, options and exchange-traded funds based on the S&P 500 would be grouped into one portfolio; eligible products based on IBM stock would be grouped into a separate portfolio.

Second, each portfolio is identified as falling into one of three categories, and each such category is pre-assigned a theoretical range of potential increases and decreases in the value of the underlying instrument, as follows:

PORTFOLIO TYPE[33]	**UP/DOWN MARKET MOVEMENT (HIGH & LOW VALUATION POINTS)**
High-capitalization, broad-based market index	+6% / -8%
Non-high-capitalization, broad-based market index	+/- 10%
Any other eligible product that is, or is based on, an equity security or a narrow-based index	+/- 15%

Third, each portfolio is "shocked" to determine changes in value assuming the value of the underlying instrument varies within the defined range set forth above. In particular, the firm determines the "theoretical gains and losses" for individual eligible products and related instruments at ten equidistant intervals (valuation points) within the defined "shock" range. For example, the value of the instruments in a portfolio based on an individual equity security would be calculated at +/- 3%, +/- 6%, +/- 9%, +/- 12%, and +/- 15%. (Rule 431(g)(2)(G)). The theoretical values of eligible products used in making these calculations must be derived from an approved theoretical pricing model. (Rule 431(g)(8)(B)). As previously noted, the OCC's TIMS is currently the only qualified model.

[33] Rule 431(g)(2)(G) includes footnotes with respect to the first two portfolio types stating "In accordance with section (b)(1)(i)(B) of Rule 15c3-1a (Appendix A to Rule 15c3-1)."

Fourth, within each portfolio, theoretical gains and losses for each instrument are netted fully at each valuation point to determine a potential portfolio-wide gain or loss for that valuation point. Offsets between certain portfolios of the same classification type (referred to as "product groups") may be applied to the extent permitted under SEC Rule 15c3-1a (which generally permits only limited offsets between certain index-based portfolios). (Rule 431(g)(2)(D) and (g)(8)(C)).

Finally, the required margin for each portfolio is the greater of (i) the largest portfolio-wide loss for the valuation points (i.e., the largest theoretical loss, calculated as described above), or (ii) the "per contract minimum" discussed immediately below. (Rule 431(g)(7)). For the account as a whole, the margin required is the sum of the greatest loss from each portfolio (subject to the "per contract minimum"). (Rule 431(g)(8)(D)).

2. Per Contract Minimum. The Revised Pilot establishes a "per contract minimum" equal to $0.375 for each listed option, unlisted derivative, security future product, and related instrument, multiplied by the contract's or instrument's "multiplier" (and not to exceed the market value in the case of long contracts in eligible products).[34]

The "per contract minimum" thus establishes a minimum margin requirement even when the greatest theoretical loss for a portfolio is *de minimis*. Some commenters on the Revised Pilot had objected to the $0.375 per contract minimum and recommended alternative lower minimums. In maintaining the $0.375 amount, the NYSE noted its concern about potential illiquidity in the market and "gap risk" in the event both sides of a hedge cannot be closed out simultaneously.[35]

---

34 According to the Approval Release, for a standard listed option the options market on which the options series is traded fixes the multiplier. Since a cash-settled equity option generally has a multiplier of 100, the minimum margin for one listed options contract would be $37.50. See Approval Release at 75791, n. 16. The Approval Release does not provide explicit guidance regarding the "multiplier" for unlisted derivatives (for which the notional amount of the underlying instrument could vary). Presumably, any ambiguities in this regard (or potential relief from this requirement with respect to unlisted contracts based on a significant notional amount of the underlying security) can be discussed in connection with a firm's application to include unlisted derivatives in a portfolio margining account.

35 Approval Release at 75793. Although a long swap on 100 shares of IBM arguably has the same market risk as 100 shares of IBM, the "per contract minimum" apparently applies only to the swap position (presumably because the NYSE does not have the same concerns about a firm's ability to liquidate the shares). In addition, it appears that the "per contract minimum" does not take into account potentially significant differences in the notional value of shares underlying a contract (i.e., if

(continued. . .)

3. Proprietary Models. As noted above, firms must use a theoretical pricing model that is approved by the SEC,[36] and TIMS is currently the only model so approved. Concerns have been raised about whether TIMS will be available to provide theoretical prices for unlisted derivatives. The SEC staff has indicated informally, however, that they are willing to review and approve firms' proprietary pricing models for purposes of transactions in unlisted derivatives. To date, the procedures for obtaining such approvals, and the standards that firms would need to satisfy (e.g., in terms of testing requirements, etc.) have not been specified. This process may be somewhat easier for CSE broker-dealers (or firms with an OTC derivatives dealer) who already have obtained SEC approval for certain proprietary models for capital purposes.

SEC staff has indicated informally that firms seeking to include unlisted derivatives should contact the SEC and NYSE promptly to initiate discussions regarding potential review of their pricing models for these products.

F. Satisfying Portfolio Margin Requirements.

1. Three Business Days to Satisfy Deficiency. If, as of the close of business, the equity in a portfolio margin account is less than the required margin, the eligible participant has three business days to deposit additional funds or securities or establish a hedge to meet the margin requirement.

According to the Revised Pilot, if the margin deficiency is not eliminated after three business days, (i) the member firm is prohibited from accepting new opening orders, except those entered into for the purpose of reducing market risk and that would lower margin requirements, and (ii) the member firm must liquidate positions in an amount sufficient to, at a minimum, lower the total margin required to an amount less than or equal to the account equity. (Rule 431(g)(10)(A)).

The NYSE (or the member firm's DEA, if different) may grant additional time for an eligible participant to meet a portfolio margin deficiency upon written request.

(. . . continued)

they have the same multiplier, a swap on stock A would be subject to the same "per contract minimum" as a swap on stock B, even if the values of stocks A and B are very different).

36 Previous versions of the pilot program required that theoretical pricing models be approved by a DEA and reviewed by the SEC.

The Revised Pilot states, however, that such requests are expected to be granted only in extraordinary circumstances. (Rule 431(g)(10)(D)).

2. Limits on Meeting Margin Deficiency Through Liquidation. The Revised Pilot prohibits member firms from permitting eligible participants to make a practice of meeting a portfolio margin deficiency by liquidation. It also requires firms to have procedures in place to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and to take appropriate action where warranted. Liquidations to eliminate margin deficiencies that are caused solely by adverse price movements (as opposed to new transactions) may be disregarded. (Rule 431(g)(10)(E)).

3. Capital Charges for Margin Deficiencies. If a deficiency is not met by the close of business on the next business day after the deficiency arose, the member firm is required to take a net capital charge in the amount of the deficiency until it is satisfied. However, such capital charges do not serve in lieu of the eligible participant's obligation to eliminate the margin deficiency as described above. (Rule 431(g)(10)(B) and (C)).

4. Assets Eligible to Meet Margin Requirements. Securities that are not eligible for portfolio margining may be carried in a portfolio margin account if the member has the ability to apply traditional position-based margin requirements to those securities. Thus, non-equity securities may be carried in the account and used to satisfy portfolio margin requirements, subject to satisfying the normally applicable margin requirements for such securities. In addition, shares of a money market mutual fund may be carried in a portfolio margin account as collateral if they are subject to applicable position-based margin requirements and:

(i) The customer waives any right to redeem the shares without the member's consent;

(ii) The member (or, if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem the shares in cash upon request;

(iii) The fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request; and

(iv) The member complies with the requirements of Exchange Act Section 11(d)(1) and Rule 11d1-2 thereunder.[37] (Rule 431(g)(7)(D)).

5. Account Guarantees. Account guarantees pursuant to NYSE Rule 431(f)(4) may not be used to satisfy portfolio margin requirements. (Rule 431(g)(7)(C)).

6. Transfers from Other Accounts. If a portfolio margin account is carried as a sub-account of a margin account, excess equity in the margin account (determined in accordance with the rules applicable to such margin account) may be used to satisfy a margin deficit in the portfolio margin sub-account without any transfer of funds or securities. If a portfolio margin account is not a sub-account of the margin account, a margin deficit in the portfolio margin account may not be satisfied by excess equity in another account. Instead, funds or securities must be transferred and a written record must be created and maintained. (Rule 431(g)(6)(A)).

G. Capital-Related Limits on Credit in Portfolio Margin Accounts. The Revised Pilot requires a member firm to immediately notify the NYSE (or its DEA, if different) and the SEC if the firm's aggregate portfolio margin requirements for all portfolio margin accounts exceed ten times its net capital. (Rule 431(g)(12)(B)). In addition, the Revised Pilot prohibits a firm from permitting aggregate portfolio margin requirements to exceed this limit for any period exceeding three business days, and beginning on the fourth business day the member firm may not open new portfolio margin accounts until it is in compliance with the limit. (Rule 431(g)(12)(A)).

H. Day Trading in a Portfolio Margin Account. The day trading margin requirements of Rule 431(f)(8)(B) do not apply to portfolio margin accounts that establish and maintain at least $5 million in equity, if the member firm has the ability to monitor intra-day risk associated with day trading.

Portfolio margin accounts that do not have $5 million in equity are subject to the day trading restrictions of Rule 431(f)(8)(B) (and presumably the member must have the ability to apply such day trading requirements before permitting such accounts to day trade). However, these day trading restrictions do not apply if the positions day traded were part of a hedge strategy – defined as "a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio." Member firms are expected to monitor

[37] See Securities Industry Association, June 8, 2006 (SEC no-action letter regarding extensions of credit on money market funds in connection with automatic sweep services).

portfolio margin accounts to "detect and prevent circumvention of the day trading requirements." (Rule 431(g)(13)).

As initially proposed by the NYSE, the Revised Pilot prohibited day trading in a portfolio margin account. Commenters argued that this prohibition was unnecessary in light of the requirement that firms monitor risk on an intra-day basis and was inconsistent with a risk-based margining system. The NYSE stated that the day-trading prohibition "is not intended to prohibit intraday trading in an account that contains a large portfolio of hedged instruments."[38] However, it is not entirely clear what firms must do under the Revised Pilot to "detect and prevent circumvention of the day trading requirements," or how they will determine whether day trades involve transactions that reduce a "material portion" of the risk in a portfolio. It is also not clear how firms will monitor intra-day risk, particularly in the context of prime brokerage arrangements in which trades done away may be reported to the prime broker after the close of business.[39]

IV. Open Issues Regarding Cross-Margining.

Commenters on the Revised Pilot raised a number of questions about the most efficient mechanism for establishing a cross-margining regime involving securities and futures. Some argued that customer cross-margining should be achieved by establishing two separate accounts – a futures account for futures positions, and a securities account for securities positions – each governed by the rules normally applicable to such accounts (except that futures positions presumably could be taken into consideration in establishing margin requirements for the securities account). This approach is sometimes referred to as a "two pot" model. Other industry participants advocated including all futures and securities positions in a single account – the so-called "one pot" approach. Commenters discussed a range of legal, operational and practical issues associated with these two different approaches.[40]

38 Approval Release at 75793.

39 This issue of how prime brokers will monitor intra-day risk, as required by the Revised Pilot (Part III.A.2(iii) above), arises even outside the day-trading context.

40 For example, comments addressed various related issues associated with cross-margining at the clearinghouse level. If a firm is not able to cross-margin positions in its clearinghouse accounts (i.e., if it is not eligible to receive the same beneficial cross-margining that it offers to its customers), the firm may in effect be required to post more margin to the clearinghouses than it receives from its

(continued. . .)

The Revised Pilot adopted the "one pot" approach – all securities and futures are held in a portfolio margin account, which is treated as a securities account. The NYSE stated the "one pot" approach would "provide more efficient margining, reduce broker-dealer/FCM liquidity risk and reduce operational inefficiencies."[41] However, this approach leaves unresolved a number of significant regulatory and operational issues associated with carrying futures positions in a securities account. These issues, two of which are discussed below, effectively limit the use of cross-margining under the Revised Pilot. In addition, it should be noted that in light of the continuing review of these issues it is possible that the approach under the Revised Pilot could be modified at some point to reflect a "two-pot" model or even some other alternative.

A. <u>Commodity Exchange Act ("CEA") Segregation Issues</u>. Carrying futures positions in a securities account, such as the portfolio margin account, raises significant issues under the customer asset segregation regime applicable to futures. Securities and futures are both subject to regulatory requirements designed to protect customers in the event of an insolvency of the carrying broker-dealer or FCM, but these regimes impose very different requirements. In particular, Section 4d(a)(2) of the CEA and Rule 1.20 thereunder require an FCM to segregate customer assets entirely from the FCM's own assets or assets of non-customers. In contrast, SEC Rule 15c3-3 and related rules impose a "net" segregation requirement under which a broker-dealer must segregate only a certain portion of customer funds and securities (depending on the amounts customers owe to the broker-dealer).

It has been noted that the inclusion of futures in a portfolio margin account, which is a securities account in which assets are not subject to segregation in aggregate, would conflict with the segregation provisions of the CEA. Accordingly, relief from these segregation requirements would appear to be necessary to permit futures margin to be held in the portfolio margin account and segregated on a net basis. Although to date the CFTC has not formally addressed the issue, on certain occasions CFTC staff members have informally raised questions about the CFTC's authority under the CEA to provide such relief.

(. . . continued)

customers. Such a result would impose an economic cost that firms are likely to pass on to customers, and may undermine the net benefits to customers of cross-margining.

[41] Approval Release at 75793.

B. Insolvency Implications. The NYSE's adoption of a "one pot" approach also raises questions about the status of securities and futures positions in the event of the insolvency of the carrying firm. Broker-dealer insolvencies are generally subject to the Securities Investor Protection Act of 1970 ("SIPA") under which certain "customer" claims are generally afforded priority over general creditors with respect to "customer property." FCM insolvencies are generally subject to the commodity broker liquidation provisions of the U.S. Bankruptcy Code, as amended, and related CFTC regulations. There is some uncertainty as to the interplay between the two regimes. For example, it is not clear whether a person would be considered to be a "customer" under SIPA for claims with respect to assets other than securities, such as futures margin or positions, carried in a securities account. If a person were not considered a "customer" for these purposes, the person would risk being deemed a general creditor of the broker-dealer with respect to futures-related positions. It has been reported that the SEC staff is working on draft amendments to Rule 15c3-3 intended to address certain of these issues under SIPA.

* * *

Please contact Robert W. Cook (202-974-1538), Ardith G. Eymann (202-974-1873) or Nathaniel F. Stankard (202-974-1543) in the Firm's Washington, D.C. office with any questions regarding this memorandum or the Revised Pilot.

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 45 63 66 37 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 501 258 5006
7 501 258 5011 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax