market's orders to ITS would violate the Plan and would be inconsistent with the Plan's intention.

The adoption of a formula is reasonable in this instance to address the participants' concerns. The Fourteenth Amendment should prevent the PCX Application from being used as an automated order delivery device to obtain cost-free, non-member access to other market centers, while at the same time giving OptiMark an opportunity to offer an innovative new service to investors.

### V. Conclusion

*It Is Therefore Ordered*, pursuant to Section 11A(a)(3)(B) of the Act,[20] that the amendment be approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[21]

**Margaret H. McFarland,**

*Deputy Secretary.*

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[20] 15 U.S.C. 78k–1(a)(3)(B).

[21] 17 CFR 200.30–3(a)(29).

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## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–41658; File No. SR–CBOE–97–67]**

## Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1 and 2 to Proposed Rule Change Revising the Exchange's Margin Rules

July 27, 1999.

### I. Introduction

On December 29, 1997, the Chicago Board Options Exchange, Incorporated (''Exchange'' or ''CBOE'') submitted to the Securities and Exchange Commission (''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 to revise and restructure the Exchange's margin requirements for stock options, stock index options, and other securities, as currently set forth in CBOE Rule 12.3, ''Margin Requirements.'' The proposed rule change was published for comment in the **Federal Register** on May 4, 1998.[3] The Commission received 4 comment letters with respect to the proposal.[4]

The Exchange submitted Amendment No. 1 to the proposal on January 7, 1999,[5] and Amendment No. 2 on May 26, 1999.[6] This order approves the proposed rule change and accelerates approval of Amendment Nos. 1 and 2.

### II. Description of the Proposal

*A. Background*

Until several years ago, the margin requirements governing listed options were set forth in Regulation T, ''Credit by Brokers and Dealers.'' [7] However, Federal Reserve Board amendments to Regulation T that became effective June 1, 1997, modified or deleted certain margin requirements regarding options transactions in favor of rules to be adopted by the options exchanges, subject to approval by the Commission.[8] In a CBOE rule filing approved by the Commission in 1997, the Exchange adopted certain options-related margin requirements that were dropped from Regulation T by the Federal Reserve Board.[9]

At the present time, the Exchange seeks to further revise its margin rules to implement enhancements long desired by Exchange members and member firms, public investors, and the Exchange staff. The Exchange believes that certain multiple options position strategies and other strategies that combine stock with option positions warrant more equitable margin requirements. The Exchange further believes that the offset in risk that results if the stock and options position are viewed collectively is not reflected in the current maintenance margin requirements. In addition, the Exchange believes it is appropriate for member firms to extend credit on certain types of long term options.

In sum, the proposed revisions to the Exchange's margin rules would: (i) Permit the extension of credit on certain long term options and certain long box spread; (ii) recognize butterfly and box spreads as strategies for purposes of margin treatment and establish appropriate margin requirements; (iii) recognize various strategies involving stocks (or other underlying instruments) paired with long options, and provide for lower maintenance margin requirements on such hedged stock positions; (iv) expand the types of short positions that would be considered ''covered'' in a cash account, specifically, certain short positions that are components of limited-risk spread strategies (*e.g.*, butterfly and box spreads); (v) allow a bank-issued escrow agreement to serve as cover in lieu of cash for certain spread positions held in a cash account; (vi) consolidate in one chapter, the various margin requirements that presently are dispersed throughout the Exchange's rules; and (vii) revise and update, as necessary, other Exchange rules impacted by the proposal.

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 39925 (April 27, 1998), 63 FR 24580.

[4] *See* Letter from Robert C. Sheehan, President, Robert C. Sheehan and Associates, to Jonathan Katz, Secretary, Commission, dated March 26, 1999 (''Sheehan Letter''); Letter from Alvin Wilkinson to Jonathan Katz, Secretary, Commission, dated March 25, 1999 (''Wilkinson Letter''); Letter from William C. Floersch, President and CEO, O'Connor & Company, to Jonathan G. Katz, Secretary, Commission, dated April 5, 1999 (''O'Connor Letter''); and Letter from Lon Gorman, Executive Vice President, Charles Schwab & Co., to Jonathan G. Katz, Secretary, Commission, dated April 13, 1999 (''Schwab Letter'').

[5] With respect to options that are not proposed to be marginable, Amendment No. 1 specifies that margin must be deposited and maintained equal to at least 100% of the current market value, rather than 100% of the purchase price. Amendment No. 1 also incorporates into the proposed rule text a definition of ''OTC margin bond,'' which has been eliminated from Regulation T by the Board of Governors of the Federal Reserve System as of April 1, 1998. Finally, Amendment No. 1 deletes from the proposal the provision that would have allowed the use of unit investment trusts (''UITs'') or open-end mutual funds (''mutual funds'') as offsets, or cover, for short index option positions held in customer margin or cash accounts, provided that the UIT or mutual fund replicated the index underlying the option, and the Exchange had specifically approved such UIT or mutual fund. As a replacement, the Exchange proposes to allow customers to use underlying open-end index mutual funds of sufficient aggregate market value as cover for short S&P 500 call options held in customer margin or cash accounts, provided the mutual funds have been specifically designated by the Exchange. *See* Letter from Mary L. Bender, Senior Vice President, Division of Regulatory Services, Exchange, to Michael A. Walinskas, Associate Director, Division of Market Regulation (''Division''), Commission, dated December 23, 1998 (''Amendment No. 1'').

[6] Amendment No. 2 revises the proposal by limiting loan value to long term stock options, stock index options, and stock index warrants. The Exchange had originally proposed to allow loan value on any long term option, regardless of the underlying instrument (*e.g.*, foreign currency options and options on interest rate composites would be marginable). Amendment No. 2 also corrects an error in the Exchange's purpose statement regarding the net credit received for selling a box spread. *See* Letter from Mary L. Bender, Senior Vice President, Division of Regulatory Services, Exchange, to Michael A. Walinskas, Associate Director, Division, Commission, dated May 14, 1999 (''Amendment No. 2'').

[7] 12 CFR 220 *et seq.* The Board of Governors of the Federal Reserve System (''Federal Reserve Board'') issued Regulation T pursuant to the Act.

[8] *See* Board of Governors of the Federal Reserve System Docket No. R–0772 (Apr. 24, 1996), 61 FR 20386 (May 6, 1996) (permitting the adoption of margin requirements ''deemed appropriate by the exchange that trades the option, subject to the approval of the Securities and Exchange Commission'').

[9] *See* Securities Exchange Act Release No. 38709 (June 2, 1997), 62 FR 31643 (June 10, 1997).

*B. Definitions*

Presently, the Exchange's definition of ''current market value'' is equivalent to the definition found in Regulation T.[10] Instead of repeating the Regulation T definition, the proposal would revise the definition found in the Exchange's rules to note that the meaning of the term ''current market value'' is as defined in Regulation T.

The Exchange also seeks to establish definitions for ''butterfly spread'' [11] and ''box spread'' [12] options strategies. The definitions are important elements of the Exchange's proposal to recognize and specify cash and margin account requirements for butterfly and box spread. The definitions will specify what multiple option positions, if held together, qualify for classification as butterfly or box spreads, and consequently are eligible for the proposed cash and margin treatment.

The proposal also would define the term ''OTC martin bond.'' [13] The definition is necessary because the Exchange's margin rules currently cross-reference the Regulation T definition of ''OTC margin bond,'' which was eliminated by the Federal Reserve Board as of April 1, 1998.[14]

Finally, the proposal would define the term ''listed,'' [15] Because ''listed'' is frequently used in the Exchange's margin rules, the Exchange believes it would be more efficient to define the term once rather than specifying the meaning each time the term is utilized.

*C. Extensions of Credit on Long Term Options and Warrants*

The proposal would allow extensions of credit on certain listed, long options (*i.e.,* listed put or call options on a stock or stock index) and warrant products (*i.e.,* listed stock index warrants, but not traditional stock warrants issued by a corporation on its own stock.[16] Only those options or warrants that are more than 9 months from expiration (''long term'') would be eligible for credit extension.[17] The proposal requires initial and maintenance margin of not less than 75% of the current market value of a long term listed option or warrant. Therefore, an Exchange member firm would be able to loan up to 25% of the current market value of a long term listed option or warrant.[18]

The proposal also would permit the extension of credit on certain long term options and warrants not listed or traded on a registered national securities exchange or a registered securities association (''OTC options and warrants''). Specifically, a member firm could extend credit on an OTC put or call option on a stock or stock index, and an OTC stock index warrant. In addition to being more than 9 months from expiration, a marginable OTC option or warrant must: (i) Be in-the-money; [19] (ii) be guaranteed by the carrying broker-dealer; and (iii) have an American-style exercise provision.[20] The proposal requires initial and maintenance margin of not less than 75% of the long term OTC option's or warrant's in-the-money amount (*i.e.,* intrinsic value), plus 100% of the amount, if any, by which the current market value of the OTC option or warrant exceeds the in-the-money amount.

When the time remaining until expiration for an option or warrant (listed and OTC) on which credit has been extended reaches nine months, the maintenance margin requirement would become 100% of the current market value. Thus, options or warrants expiring in less than 9 months would have no loan value under the proposal.

*D. Extensions of Credit on Long Box Spread in European-Style Options*

The proposal would allow the extension of credit on a long box spread comprised entirely of European-style options [21] that are listed or guaranteed by the carrying broker-dealer. A long box spread is a strategy composed of four option positions that is designed to lock in the ability to buy and sell the

[10] Regulation T defines ''current market value'' of a security to be:

(i) Throughout the day of the purchase or sale of a security, the security's total cost of purchase or the net proceeds of its sale including any commissions charged; or (ii) At any other time, the closing sale price of the security on the preceding business day, as shown by any regularly published reporting or quotation service. If there is no closing sale price, the creditor may use any reasonable estimate of the market value of the security as of the close of business on the preceding business day.

*See* 12 CFR 220.2.

[11] The proposal defines ''butterfly spread'' as:

[A]n aggregation of positions in three series of either put or call options all having the same underlying component or index and time of expiration, and based on the same aggregate current underlying value, where the interval between the exercise price of each series is equal, which positions are structured as either (A) a ''long butterfly spread'' in which two short options in the same series are offset by one long option with a higher exercise price and one long option with a lower exercise price, or (B) a ''short butterfly spread'' in which two long options in the same series offset one short option with a higher exercise price and one short option with a lower exercise price.

[12] The proposal defines ''box spread'' as:

[A]n aggregation of positions in a long call option and short put option with the same exercise price (''buy side'') coupled with a long put option and short call option with the same exercise price (''sell side'') all of which have the same underlying component or index and time of expiration, and are based on the same aggregate current underlying value, and are structured as either: (A) A ''long box spread'' in which the sell side exercise price exceeds the buy side exercise price, or (B) a ''short box spread'' in which the buy side exercise price exceeds the sell side exercise price.

[13] The proposal defines ''OTC margin bond'' as:

(1) Any debt securities not traded on a national securities exchange that meet all of the following requirements (a) at the time of the original issued, a principal amount of not less than $25,000,000 of the issue was outstanding; (b) the issue was registered under Section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to the Act or is an insurance company under Section 12(g)(2)(G) of the Act; or (c) at the time of the extension of credit the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments; or (2) any private pass-through securities (not guaranteed by a U.S. Government agency) that meet all of the following requirements: (a) An aggregate principal amount of not less than $25,000,000 was issued pursuant to a registration statement filed with the Commission; and (b) current reports relating to the issue have been filed with the Commission; and (c) at the time of the credit extension, the creditor has a reasonable basis for believing that mortgage interest, principal payments and other distributions are being passed through as required and that the servicing agent is meeting its material obligations under the terms of the offering.

[14] *See* Board of Governors of the Federal Reserve System Docket Nos. R–0905, R–0923, and R–0944 (Jan. 8, 1998), 63 FR 2806 (Jan. 16, 1998).

Under the proposal, the term ''listed'' means ''a security traded on a registered national securities exchange or automated facility of a registered national securities association.

[16] Throughout the remainder of this approval order, the term ''warrant'' means this type of warrant.

[17] In the case of any stock option, stock index option, or stock index warrant, which expires in 9 months or less, initial margin must be deposited and maintained equal to at least 100% of the current market value of the option or warrant.

[18] For example, if an investor purchased an Exchange-listed call option on stock XYZ that expired in January 2001 for approximately $100 (excluding commissions), the investor would be required to deposit and maintain at least $75. The investor could borrow the remaining $25 from its broker. Under the Exchange's current margin rules, the investor would be required to pay the entire $100.

[19] The Exchange stated that it proposes to restrict loan value to long term OTC options and warrants that are in-the-money because ''a liquid secondary market for an over-the-counter option or warrant does not generally exist. Therefore, a current bid or offer price, or last sale price, is not readily available.'' In addition, the Exchange noted that because OTC options are not obligations of the AAA-rated Options Clearing Corporation, their value may vary depending upon the creditworthiness of the issuer. The Exchange concluded that ''loaning on over-the-counter options without intrinsic value posed too much uncertainty to the creditor as to the value of the collateral'' As a result, the only OTC options that would be deemed eligible for credit are in-the-money options, because ''their value can reasonably be expected to be at least equal to their intrinsic value.'' *See* Letter to Michael Walinskas, Associate Director, Division, Commission, from Mary L. Bender, Senior Vice President, Division of Regulatory Services, Exchange, dated May 21, 1998.

[20] Exchange Rule 1.1(vv), ''American-style Option,'' states that an American-style option is an option contract that ''can be exercised on any business day prior to its expiration date and on its expiration date.''

[21] Exchange Rule 1.1(uu), ''European-style Option,'' states that a European-style option is an option contract that ''can be exercised only on its expiration date.''

underlying component or index for a profit, even after netting the cost of establishing the long box spread. The two exercise prices embedded in the strategy determine the buy and the sell price.[22]

For long box spreads made up of European-style options, the proposed margin requirement would equal 50% of the aggregate difference in the two exercise prices (buy and sell), which results in a requirement slightly higher than 50% of the debit typically incurred.[23] The 50% margin requirement is both an initial and maintenance margin requirement. The proposal would afford a long box spread a market value for margin equity purposes of not more than 100% of the aggregate difference in exercise prices.

*E. Cash Account Treatment of Butterfly and Box Spreads, Other Spreads, and Short Options*

The proposal would make butterfly spreads and box spreads in cash-settled, European-style options eligible for the cash account. A butterfly spread is a pairing of two standard spreads, one bullish and one bearish. To qualify for carrying in the cash account, the butterfly spreads and box spreads must meet the specifications contained in the proposed definition section,[24] and must be comprised of options that are listed or guaranteed by the carrying broker-dealer. In addition, the long options must be held in, or purchased for, the account on the same day.

For long butterfly spreads and long box spreads, the proposal would require full payment of the net debit that is incurred when the spread strategy is established.[25]

Short butterfly spreads generate a credit balance when established (*i.e.*, the proceeds from the sale of short option components exceed the cost of purchasing long option components). However, in the worst case scenario where all options are exercised, a debit (loss) greater than the initial credit balance received would accrue to the account. To eliminate the risk to the broker-dealer carrying the short butterfly spread, the proposal would require that an amount equal to the maximum risk be held or deposited in the account in the form of cash or cash equivalents.[26] The maximum risk potential in a short butterfly spread comprised of call options is the aggregate difference between the two lowest exercise prices.[27] With respect to short butterfly spreads comprised of put options, the maximum risk potential is the aggregate difference between the two highest exercise prices. The net credit received from the sale of the short option components could be applied towards the requirement.

Short box spreads also generate a credit balance when established. This credit is nearly equal to the total debit (loss) that, in the case of a short box spread, will accrue to the account if held to expiration. The proposal would require that cash or cash equivalents covering the maximum risk, which is equal to the aggregate difference in the two exercise prices involved, be held or deposited.[28] The net credit received from the sale of the short option components may be applied towards the requirement; if applied, only a small fraction of the total requirement need be held or deposited.[29]

In addition to butterfly spreads and box spreads, the proposal would permit investors to hold in their cash accounts other spreads made up of European-style, cash-settled index options, stock index warrants, or currency index warrants. A short position would be considered covered, and thus eligible for the cash account, if a long position in the same European-style, cash-settled index option, stock index warrant, or currency index warrant was held in, or purchased for, the account on the same day.[30] The long and short positions making up the spread must expire concurrently, and the long position must be paid in full. Lastly, the cash account must contain cash, cash equivalents, or an escrow agreement equal to at least the aggregate exercise price differential.

The proposal also would establish requirements for the following types of options and warrants carried short in the cash account: equity options, index options, capped-style index options, packaged vertical spread options, packaged butterfly spread options, stock index warrants, and currency index warrants. For each of these securities, the proposal specifies certain criteria that must be satisfied for the short position to be deemed a covered position, and thus considered eligible for the cash account. For example, a short put warrant on a market index would be deemed covered if, at the time the put warrant is sold or promptly thereafter, the cash account holds cash, cash equivalents, or an escrow agreement equal to the aggregate exercise price.

[22] For example, an investor might be long 1 XYZ Jan 50 Call @ 7 and short 1 XYZ Jan 50 Put @ 1 (''buy side''), and short 1 XYZ Jan 60 Call @ 2 and long 1 XYZ Jan 60 Put @ 5½ (''sell side''). As required by the Exchange's proposed definition of ''long box spread'' (*supra* note 12), the sell side exercise price exceeds the buy side exercise price. In this example, the long box spread is a riskless position because the net debit ((2+1) − (7+5½)= net debit of 9½) is less than the exercise price differential (60 − 50=10). Thus, the investor has locked in a profit of $50 (½× 100).

[23] In the example appearing in the preceding footnote, the margin required (50% × (60 − 50) = 5) would be slightly higher than 50% of the net debit (50% × 9½ = 4¾).

[24] *See supra* notes 11 and 12.

[25] To create a long butterfly spread, which is comprised of call options, an investor may be long 1 XYZ Jan 45 Call @ 6, short 2 XYZ Jan 50 Calls @ 3 each, and long 1 XYZ Jan 55 Call @ 1. The maximum risk for this long butterfly spread is the net debit incurred to establish the strategy ((3+3) − (6+1)= net debit of 1). Under the proposal, therefore, the investor would be required to pay the net debit, or $100 (1 × 100).

[26] An escrow agreement could be used as a substitute for cash or cash equivalents if the agreement satisfies certain criteria. For short butterfly spreads, the escrow agreement must certify that the bank holds for the account of the customer as security for the agreement (1) cash, (2) cash equivalents, or (3) a combination thereof having an aggregate market value at the time the positions are established of not less than the amount of the aggregate difference between the two lowest exercise prices with respect to short butterfly spreads comprised of call options or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of put options and that the bank will promptly pay the member organization such amount in the event the account is assigned an exercise notice on the call (put) with the lowest (highest) exercise price.

[27] For example, an investor may be short 1 XYZ Jan 45 Call @ 6, long 2 XYZ Jan 50 Calls @ 3 each, and short 1 XYZ Jan 55 Call @ 1. Under the proposal, the maximum risk for this short butterfly spread, which is comprised of call options, is equal to the difference between the two lowest exercise prices (50 − 45=5). If the net credit received from the sale of short option components ((6+1) − (3+3)= net credit of 1) is applied, the investor is required to deposit an additional $400 (4 × 100). Otherwise, the investor would be required to deposit $500 (5 × 100).

[28] As a substitute for cash or cash equivalents, an escrow agreement could be used if it satisfies certain criteria. For short box spreads, the escrow agreement must certify that the bank holds for the account of the customer as security for the agreement (1) cash, (2) cash equivalents, or (3) a combination thereof having an aggregate market value at the time the positions are established of not less than the amount of the aggregate difference between the exercise prices and that the bank will promptly pay the member organization such amount in the event the account is assigned an exercise notice on either short option.

[29] To create a short box spread, an investor may be short 1 XYZ Jan 60 Put @ 5½ and long 1 XYZ Jan 60 Call @ 2 (''buy side''), and short 1 XYZ Jan 50 Call @ 7 and long 1 XYZ Jan 50 Put @ 1 (''sell side''). As required by the Exchange's proposed definition of ''short box spread'' (*supra* note 12), the buy side exercise price exceeds the sell side exercise price. In this example, the maximum risk for the short box spread is equal to the difference between the two exercise prices (60 − 50=10). If the net credit received from the sale of short option components ((5½+7) − (2+1)=net credit of 9½) is applied, the investor is required to deposit an additional $50 (½ × 100). Otherwise, the investor would be required to deposit $1,000 (10 × 100).

[30] Under the proposal, a long warrant may offset a short option contract and a long option contract may offset a short warrant provided they have the same underlying component or index and equivalent aggregate current underlying value.

*F. Margin Account Treatment of Butterfly Spreads and Box Spreads*

The Exchange's margin rules presently do not recognize butterfly spreads for margin purposes. Under the Exchange's current margin rules, the two spreads (bullish and bearish) that make up a butterfly spread each must be margined separately. The Exchange believes that the two spreads should be viewed in combination, and that commensurate with the lower combined risk, investors should receive the benefit of lower margin requirements.

The Exchange's proposal would recognize as a distinct strategy butterfly spreads held in margin accounts, and specify requirements that are the same as the cash account requirements for butterfly spreads.[31] Specifically, in the case of a long butterfly spread, the net debit must be paid in full. For short butterfly spreads comprised of call options, the initial and maintenance margin must equal at least the aggregate difference between the two lowest exercise prices. For short butterfly spreads comprised of put options, the initial and maintenance margin must equal at least the aggregate difference between the two highest exercise prices. The net credit received from the sale of the short option components may be applied towards the margin requirement for short butterfly spreads.

The proposed requirements for box spreads held in a margin account, where all option positions making up the box spread are listed or guaranteed by the carrying broker-dealer, also are the same as those applied to the cash account. With respect to long box spreads, where the component options are not European-style, the proposal would require full payment of the net debit that is incurred when the spread strategy is established.[32] For short box spreads held in the margin account, the proposal would require that cash or cash equivalents covering the maximum risk, which is equal to the aggregate difference in the two exercise prices involved, be deposited and maintained. The net credit received from the sale of the short option components may be applied towards the requirement. Generally, long and short box spreads would not be recognized for margin equity purposes; however, the proposal would allow loan value for one type of long box spread where all component options have a European-style exercise provision and are listed or guaranteed by the carrying broker-dealer.

*G. Maintenance Margin Requirements for Stock Positions Held With Options Positions*

The Exchange proposes to recognize, and establish reduced maintenance margin requirements for, five options strategies designed to limit the risk of a position in the underlying component. The strategies are: (1) Long Put/Long Stock: (2) Long Call/Short Stock; (3) Conversion; (4) Reverse Conversion; and (5) Collar. Although the five strategies are summarized below in terms of a stock position held in conjunction with an overlying option (or options), the proposal is structured to also apply to components that underlie index options and warrants. For example, these same maintenance margin requirements will apply when these strategies are utilized with a stock basket underlying index options or warrants. Proposed Exchange Rule 12.3(c)(5)(C)(3), ''Exceptions,'' would define the five strategies and set forth the respective maintenance margin requirements for the stock component for each strategy.[33]

1. Long Put/Long Stock

The Long Put/Long Stock strategy requires an investor to carry in an account a long position in the component underlying the put option, and a long put option specifying equivalent units of the underlying component. The maintenance margin requirement for the Long Put/Long Stock combination would be the lesser of: (i) 10% of the put option exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (ii) 25% of the current market value of the long stock position.[34]

2. Long Call/Short Stock

The Long Call/Short Stock strategy requires an investor to carry in an account a short position in the component underlying the call option, and a long call option specifying equivalent units of the underlying components. For a Long Call/Short Stock combination, the maintenance margin requirement would be the lesser of: (i) 10% of the call option exercise price, plus 100% of any amount by which the call option is out-of-the-money; or (ii) the maintenance margin requirement on the short stock position as specified in CBOE rule 12.3(b).[35]

3. Conversion

A ''Conversion'' is a long stock position held in conjunction with a long put and a short call. The long put and short call must have the same expiration date and exercise price. The short call is covered by the long stock and the long put is a right to sell the stock at a predetermined price—the exercise price of the long put. Regardless of any decline in market value, the stock, in effect, is worth no less than the long put exercise price.

The Exchange's current margin regulations specify that no maintenance margin would be required on the short call option because it is covered, but the underlying long stock position would be margined according to the present maintenance margin requirement (*i.e.*, 25% of current market value).[36] Under the proposal, the maintenance for a

[31] *See supra*, Section II(E), ''Cash Account Treatment of Butterfly and Box Spreads, Other Spreads, and Short Options.'' The margin requirements would apply to butterfly spreads where all option positions are listed or guaranteed by the carrying broker-dealer.

[32] As discussed above in Section II(D), ''Extension of Credit on Long Box Spread in European-style Options,'' the margin requirement for a long box spread made up of European-style options is 50% of the aggregate difference in the two exercise prices.

[33] The Exchange's proposal provides maintenance margin relief for the stock component (or other underlying instrument) of the five identified strategies. The Exchange believes that a reduction in the initial margin for the stock component of these strategies is not currently possible because the 50% initial margin requirement under Regulation T continues to apply, and the Exchange does not possess the independent authority to lower the initial margin requirement for stock. However, the Exchange noted that the Federal Reserve Board is considering recognizing the reduced risk afforded stock by these option strategies for the purpose of lowering initial stock margin requirements and is also considering other changes that would facilitate risk-based margins.

[34] Suppose an investor is long 100 shares of XYZ @ 52 and long 1 XYZ Jan 50 Put @ 2. The margin would be the lesser of ((10% × 50) + (100% × 2) = 7) or (25% × 52 = 13). Therefore, the investor would be required to maintain margin equal to at least $700 (7 × 100).

[35] For each stock carried short that has a current market value of less than $5 per share, the maintenance margin is $2.50 per share or 100% of the current market value, whichever is greater. For each stock carried short that has a current market value of $5 per share or more, the maintenance margin is $5 per share or 30% of the current market value, whichever is greater. *See* Exchange Rule 12.3(b)(2), ''Short Positions.''

Suppose an investor is short 100 shares of XYZ @ 48 and long 1 XYZ Jan 50 Call @ 1. The margin would be the lesser of ((10% of 50) =7) or 30% × 48 = 14.4). Therefore, the investor would be required to maintain margin equal to at least $700 (7 × 100).

[36] Suppose an investor is long 100 shares of XYZ @ 48, long 1 XYZ Jan 50 Put at 2, and short 1 XYZ Jan 50 Call @ 1. The present maintenance margin on the long stock position would be $1,200 ((25% × 48) × 100). However, if the price of the stock increased to 60, current Exchange Rule 12.3(c)(5)(B)(2) specifies that the stock may not be valued at more than the short call exercise price. Thus, the maintenance margin on the long stock position would be $1,250 ((25% × 50) × 100). The writer of the call option cannot receive the benefit (*i.e.*, greater loan value) of a market value that is above the call exercise price because, if assigned an exercise, the underlying component would be sold at the exercise price, not the market price of the long position.

Conversion would be 10% of the exercise price.[37]

4. Reverse Conversion

A ''Reverse Conversion'' is a short stock position held in conjunction with a short put and a long call. As with the Conversion, the short put and long call must have the same expiration date and exercise price. The short put is covered by the short stock and the long call is a right to buy the right stock at a predetermined price—the call exercise price. Regardless of any rise in market value, the stock can be acquired for the call exercise price, in effect, the short position is valued at no more than the call exercise price. The maintenance margin requirement for a Reverse Conversion would be 10% of the exercise price, plus any in-the-money amount (*i.e.*, the amount by which the exercise price of the short put exceeds the current market value of the underlying stock position).[38]

5. Collar

A ''Collar'' is a long stock position held in conjunction with a long put and a short call. A Collar differs from a Conversion in that the exercise price of the long put is lower than the exercise price of the short call. Therefore, the options positions in a Collar do not constitute a pure synthetic short stock position. The maintenance margin for a Collar would be the lesser of: (i) 10% of the long put exercise price, plus 100% of any amount by which the long put is out-of-the-money; or (ii) 25% of the short call exercise price.[39] Under the Exchange's current margin regulations, the stock may not be valued at more than the call exercise price.

*H. Restructuring*

The proposal would replace the present margin requirement for uncovered short listed options, which appears as CBOE Rule 12.3(c)(5)(A), ''Short Listed Equity Options: General Rule,'' with current Interpretation and Policy .01 to Exchange Rule 12.3 (''Interpretation''). The Interpretation contains a table that includes: (i) Different types of listed option and warrant products; (ii) the underlying component value; (iii) the percentage used in the basic formula for calculating the margin requirement for positions carried short; and (iv) the percentage used in the alternative formula for calculating the minimum margin requirement, which becomes operative whenever the basic formula results in a lower requirement.[40] The Interpretation has been modified slightly to incorporate the margin requirements for narrow-based stock index warrants, which are currently located in Chapter 30 of the Exchange's rules.

Under the proposal, the margin requirements for uncovered short positions in OTC options would be relocated from Exchange Rule 12.3(c)(5)(B)(5) to Exchange Rule 12.3(c)(5)(B). The current text of the Exchange rule that sets forth the margin requirements for short OTC options differs from the proposed text of the rule that contains the margin requirements for short listed options (*i.e.*, the Interpretation). To establish greater consistency, the proposal would revise the rule text of the margin requirements for both listed and OTC short options to make them more similar. The methodology of calculating margin requirements for short listed and OTC options is essentially the same, only different percentages are applies.[41]

The proposal also would combine the margin requirements pertaining to long position offsets for short OTC options with those pertaining to long position offsets for short listed options. The combined margin requirements would appear in proposed Exchange Rule 12.3(c)(5)(C), ''Related Securities Position'' and would apply to listed and OTC option positions where: (i) a short call is covered by a convertible security; (ii) a short call is covered by a warrant; and (iii) a short call or short put is covered.[42] As a result, two sets of relatively identical requirements that now exist separately would be consolidated into one section.

The proposed restructuring would ensure that the margin requirements for short options and warrants are organized in one section. The restructuring also would allow the deletion of the margin requirements applicable to short options and warrants that are now dispersed among several other chapters: Chapter 23 (interest rate options), Chapter 24 (index options), and Chapter 30 (warrants). In addition, the proposal would restructure Exchange Rule 12.3 to generically cover the margin requirements for spread positions in options/warrants of the types currently addressed in other chapters.[43] Margin requirements located elsewhere that are not amenable to such generic treatment, have been incorporated into Exchange Rule 12.3 as necessary.

*I. Time Margin Must Be Obtained*

The proposal would clarify the time in which initial margin is due. Exchange Rule 12.2, ''Time Margin Must Be Obtained,'' was adopted at a time when the Exchange had authority only to set maintenance margin levels, and currently requires that margin be obtained as promptly as possible. Because the Exchange now has additional rulemaking responsibility for the initial margin requirements for options, the proposal specifies that

[37] For example in the preceding footnote, where the investor was long 100 shares of XYZ @ 48, long 1 XYZ Jan 50 Put @ 2, and short 1 XYZ Jan 50 Call @ 1, the proposed maintenance margin requirement for the Conversion strategy would be $500 ((10% × 50) × 100).

[38] The seller of a put option has an obligation to buy the underlying component at the put exercise price. If assigned an exercise, the underlying component would be purchased (the short position in the Reverse Conversion effectively closed) at the exercise price, even if the current market price is lower. To recognize the lower market value of a component, the short put in-the-money amount is added to the requirement. For example, an investor holding a Reverse Conversion may be short 100 shares of XYZ @ 52, long 1 XYZ Jan 50 Call @ 2½, and short 1 XYZ Jan 50 Put @ 1½. If the current market value of XYZ stock drops to 30, the maintenance margin would be $2,500 ((10% × 50) + (50–30)) × 100.

[39] To create a Collar, an investor may be long 100 shares of XYZ @ 48, long 1 XYZ Jan 45 Put @ 4, and short 1 XYZ Jan 50 Call @ 3. The maintenance margin requirement would be the lesser of ((10% × 45) + 3 = 7½) or (25% × 50 = 12½). Therefore, the investor would need to maintain at least $750 (7½ × 100) in margin.

[40] For example, if an investor writes an uncovered equity option, such as 1 XYZ Jan 25 Put @ 1, the investor's position would be subject to the Exchange's short option margin requirements. If the current market value of XYZ stock is $30, under the basic formula the investor would be required to deposit and maintain margin equal to at least $200 (*i.e.*, $100 (100% of the current market value of the option) + $600 (20% × $3,000 ➧ the current market value of the XYZ stock underlying the short option) − $500 (the out-of-the-money amount)). However, the alternative formula becomes operative because it requires a minimum margin that exceeds the amount required under the basic formula. Under the alternative formula, the investor would be required to deposit and maintain margin equal to at least $350 (*i.e.*, $100 (100% of the current market value of the option) + $250 (10% × $2,500 ➧ the aggregate exercise price amount of the short put option)). Therefore, the investor would be required to comply with the higher margin requirement of $350.

[41] For example, the percentage used in the basic formula for calculating the margin requirement for short listed stock options is 20%. In contrast, the percentage used with respect to short OTC stock options is 30%.

[42] In the case of short call, the position must be covered by a long position in equivalent units of the underlying security, and in the case of a short put, the position must be covered by a short position in equivalent units of the underlying security. With respect to short calls options on the S&P 500 stock index, the Exchange proposes to allow the use of long positions in underlying open-end index mutual funds as cover for short S&P 500 call options held in customer margin or cash accounts, provided the mutual funds have sufficient aggregate market value and have been specifically designated by the Exchange.

[43] For example, the margin requirements for capped-style (CAPS and Q–CAPS) index option spreads, packaged vertical spreads, and packaged butterfly spreads were moved from Chapter 24 and updated to reflect the proposed margin requirements for spreads.

initial margin requirements would be due in one ''payment period'' as defined in Regulation T.[44] The proposal also would revise Exchange Rule 12.2 to specify that maintenance margin must be obtained as promptly as possible, but in any event within 15 days. The current standard is ''within a reasonable time.''

*J. Effect of Mergers and Acquisitions on the Margin Required for Short Options*

The proposal would implement, as Interpretation and Policy .13 of Exchange Rule 12.3, an exception to the margin requirement for short options if trading in the underlying security ceases due to a merger or acquisition. The exception currently exists as part of an Exchange Regulatory Bulletin.[45] Under the proposed exception, if an underlying security ceases to trade due to a merger or acquisition, and a cash settlement price has been announced by the issuer of the option, margin would be required only for in-the-money options and would be set at 100% of the in-the-money amount.

*K. Determination of Value for Margin Purposes*

The proposal would revise Exchange rules 12.5, ''Determination of Value for Margin Purposes,'' to make it consistent with that portion of the Exchange's proposal that allows the extension of credit on certain long-term options and warrants (*i.e*, stock options, stock index options, and stock index warrants that are more than 9 months from expiration). Currently, Exchange Rule 12.5 does not allow the market value of long term options to be considered for margin equity purposes. The revision would allow options and warrants eligible for loan value under proposed Rule 12.3 to be valued at current market prices for margin purposes. This change is designed to ensure that the value of the marginable option or warrant (the collateral) is sufficient to cover the debit carried in conjunction with the purchase.

*L. Exempted Securities*

Currently, the Exchange's maintenance margin requirement for non-convertible debt securities is found in Exchange Rule 12.3(c)(1), ''Exempted Securities.'' However, the term ''non-convertible debt security'' refers to corporate bonds, which are not considered exempt securities under the Act. The Exchange seeks to rectify this misnomer by removing the margin requirement for non-convertible debt securities from the ''Exempted Securities'' section and redesignating it as a separate provision, Exchange Rule 12.3(c)(2).

**III. Summary of Comments**

The Commission received 4 comment letters regarding the proposed rule change, all of which supported the proposal.[46] One commenter, a registered broker-dealer, stated that its clients complained that the margin requirements on certain index options positions are ''much higher than the overall risk of the position[s] would indicate.'' [47] Another commenter, who acts as a market maker in S&P 500 index options at the CBOE and also serves as a member of the CBOE's Board of Directors, reported that some market participants believe that the margin requirements for offsetting spread positions are onerous, and that present margin requirements are a ''major barrier to more customer business.'' [48] This commenter stated that in some instances customers have shifted their options trades to the OTC and futures markets because the margin requirements at the CBOE are higher.[49]

One commenter believed that the proposed margin requirements will benefit investors by recognizing the limited risk of many hedged positions.[50] Another commenter believed that the current margin requirements for listed options positions, particularly hedged strategies using multiple positions, do not ''adequately recognize the defined risk of these positions.'' [51] This commenter believed that reducing the margin requirements for options strategies with defined risk will benefit customers by providing increased flexibility and lowering costs, and will better align the level of margin with the risk of the positions. This commenter also believed that the proposal would serve to ''increase the viability of listed options and the competitiveness of the options markets generally.'' [52]

In addition, all four commenters advocated the adoption of a risk-based methodology for margining options positions. One commenter believed that in terms of margin treatment, listed options are often at a disadvantage compared to similar derivative products traded on the futures exchanges (*i.e.*, the futures exchanges employ risk-based margin).[53] Another commenter believed that the availability of risk-based margin for listed options could help the options exchanges to serve more customers.[54]

**IV. Discussion**

For the reasons discussed below, the Commission finds that the proposed rule changes is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change is consistent with the Section 6(b)(5) [55] requirements that the rules of an exchange be designed to promote just the equitable principles of trade, prevent fraudulent and manipulative acts and practices, and protect investors and the public interest. The Commission also finds that the proposal may serve to remove impediments to and perfect the mechanism of a free and open market by revising the Exchange's margin requirements to better reflect the risk of certain hedged options strategies.

The Commission believes that it is appropriate for the Exchange to allow member firms to extend credit on certain long term options and warrants, and that such practice is consistent with Regulation T. In 1996, the Federal Reserve Board amended Regulation T to enable the self-regulatory organizations (''SROs'') to adopt rules permitting the margining of options.[56] The CBOE rules approved in this order are the first SRO rules that will permit the margining of options under the grant of authority from the Federal Reserve Board.

The Commission believes that it is reasonable for the Exchange to restrict the extension of credit to long term options and warrants. The Commission believes that by limiting loan value to long term options and warrants, the proposal will help to ensure that the extension of credit is backed by

[44] Regulation T defines payment period as ''the number of business days in the standard securities settlement cycle in the United States, as defined in paragraph (a) of SEC Rule 15c6–1, plus two business days.'' *See* 12 CFR 220.2.

[45] Exchange Regulatory Bulletin No. 91–29, ''Customer Margin Requirements,'' specifies the margin requirements for uncovered, short equity options that have been delisted by the Exchange due to a merger or acquisition. For out-of-the-money options, no margin is required. For in-the-money options, margin must equal the difference between the underlying stock value set by the registered clearing corporation and the strike price of the option. *See* Exchange Regulatory Bulletin Number 91–29 (April 10, 1991).

[46] *See* Sheehan Letter, Wilkinson Letter, O'Connor Letter, and Schwab Letter *supra* note 4.

[47] *See* Sheehan Letter *supra* note 4.

[48] *See* Wilkinson Letter *supra* note 4.

[49] The commenter alleged that margin requirements for certain S&P 500 index options traded on the CBOE can be as much as 2 to 16 times greater than options on S&P 500 index futures traded on the Chicago Mercantile Exchange. *Id.*

[50] *See* O'Conner Letter *supra* note 4.

[51] *See* Schwab Letter *supra* note 4.

[52] *Id.*

[53] *Id.*

[54] *See* Wilkinson Letter *supra* note 4.

[55] 15 U.S.C. 78f(b)(5).

[56] *See* Board of Governors of the Federal Reserve System Docket No. R–0772 (Apr. 24, 1996), 61 FR 20386 (May 6, 1996), and 12 CFR 220.12(f).

collateral (*i.e.*, the long term option or warrant) that has sufficient value.[57] Because the expiration dates attached to options and warrants make such securities wasting assets by nature, it is important that the Exchange restrict the extension of credit to only those options and warrants that have adequate value at the time of the purchase, and during the term of the margin loan.[58]

The Commission believes that the proposed margin requirements for eligible long term options and warrants are reasonable. For long term listed options and warrants, the proposal requires that an investor deposit and maintain margin of not less than 75% of the current market value of the option or warrant. For long term OTC options and warrants, an investor must deposit and maintain margin of not less than 75% of the long term OTC option's or warrant's-in-the-money amount (*i.e.*, intrinsic value), plus 100% of the amount, if any, by which the current market value of the OTC option or warrant exceeds the in-the-money amount. The Commission observes that the proposed margin requirements are more stringent than the current Regulation T margin requirements for equity securities (*i.e.*, 50% initial margin and 25% maintenance margin).

The Commission recognizes that because current Exchange rules prohibit loan value for options, increases in the value of long term options cannot contribute to margin equity (*i.e.*, appreciated long term options cannot be used to offset losses in other positions held in a margin account). Consequently, some customers may face a margin call or liquidation for a particular position even though they concurrently hold a long term option that has appreciated sufficiently in value to obviate the need for additional margin equity. The Exchange's proposal would address this situation by allowing loan value for long term options and warrants.

The Commission believes that it is reasonable for the Exchange to afford long term options and warrants loan value because mathematical models for pricing options and evaluating their worth as loan collateral are widely recognized and understood.[59] Moreover, some creditors, such as the Options Clearing Corporation, extend credit on options as part of their current business.[60] The Commission believes that because options market participants possess significant experience in assessing the value of options, including the use of sophisticated models, it is appropriate for them to extend credit on long term options and warrants.

Furthermore, since 1998, lenders other than broker-dealers have been permitted to extend 50% loan value against long, listed options under Regulation U.[61] The Commission understands that the current bar preventing broker-dealers from extending credit on options may place some CBOE member firms at a competitive disadvantage relative to other financial service firms. By permitting Exchange members to extend credit on long term options and warrants, the proposal should enable Exchange members to better serve customers and offer additional financing alternatives.

The Commission believes that it is appropriate for the Exchange to recognize the hedged nature of certain combined options strategies and prescribe margin and cash account requirements that better reflect the true risk of the strategy. Under current Exchange rules, the multiple positions comprising an option strategy such as a butterfly spread must be margined separately. In the case of a butterfly spread, the two component spreads (bull spread and bear spread) are margined without regard to the risk profile of the entire strategy. The net debit incurred on the bullish spread must be paid in full, and margin equal to the exercise price differential must be deposited for the bearish spread.

The Commission believes that the revised margin and cash account requirements for butterfly spread and box spread strategies are reasonable measures that will better reflect the risk of the combined positions. Rather than view the butterfly and box spread strategies in terms of their individual option components, the Exchange's proposal would take a broader approach and require margin that is commensurate with the risk of the entire, hedged position. For long butterfly spreads and long box spreads, the proposal would require full payment of the net debit that is incurred when the spread strategy is established.[62] For short butterfly spreads and short box spreads, the initial and maintenance margin required would be equal to the maximum risk potential. Thus, for short butterfly spreads comprised of call options, the margin must equal the aggregate difference between the two lowest exercise prices. For short butterfly spreads comprised of put options, the margin must equal the aggregate difference between the two highest exercise prices. For short box spreads, the margin must equal the aggregate difference in the two exercise prices involved. In each of these instances, the net credit received from the sale of the short option components may be applied towards the requirement.

The Commission believes that the proposed margin and cash account requirements for butterfly spreads and box spreads are appropriate because the component option positions serve to offset each other with respect to risk.

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[57] The value of an option contract is made up of two components: Intrinsic value and time value. Intrinsic value, or the in-the-money-accounts, is an option contract's arithmetically determinable value based on the strike price of the option contract and the market value of the underlying security. Time value is the portion of the option contract's value that is attributable to the amount of time remaining until the expiration of the option contract. The more time remaining until the expiration of the option contract, the greater the time value component.

[58] For similar reasons, the Commission believes that it is appropriate for the Exchange to permit the extension of credit on long box spread comprised entirely of European-style options that are listed or guaranteed by the carrying broker-dealer. Because the European-style long box spread locks in the ability to buy and sell the underlying component or index for a profit, and all of the component options must be exercised on the same expiration day, the Commission believes that the combined positions have adequate value to support an extension of credit.

[59] For example, the Black-Scholes model and the Cox Ross Rubinstein model are often used to price options. *See* F. Black and M. Scholes, *The Pricing of Options and Corporate Liabilities*, 81 Journal of Political Economy 637 (1973), and J.C. Cox, S. A. Ross, and M. Rubinstein, *Option Pricing: A Simplified Approach*, 7 Journal of Financial Economics 229 (1979).

[60] The Exchange stated, ''[t]he fact that market-maker clearing firms and the Options Clearing Corporation extend credit on long options demonstrates that long options are acceptable collateral to lenders. In addition, banks have for some time loaned funds to market-maker clearing firms through the Options Clearing Corporation's Market Maker Pledge Program.'' *See* Letter to Michael Walinskas, Associate Director, Division, Commission, from Mary L. Bender, Senior Vice President, Division of Regulatory Services, Exchange, dated May 21, 1998.

[61] *See* Board of Governors of the Federal Reserve System Docket Nos. R–0905, R–0923, and R–0944 (Jan. 8, 1998), 63 FR 2806 (Jan. 16, 1998). In adopting the final rules that permitted non-broker-dealer lenders to extend credit on listed options, the Federal Reserve Board states that it was:

[A]mending the Supplement to Regulation U to allow lenders other than broker-dealers to extend 50 percent loan value against listed options. Unlisted options continue to have no loan value when used as part of a mixed-collateral loan. However, banks and other lenders can extend credit against unlisted options if the loan is not subject to Regulation U [12 CFR 221 *et seq.*].

The Board first proposed margining listed options in 1995. *See* Board of Governors of the Federal Reserve System Docket No. R–0772 (June 21, 1995), 60 FR 33763 (June 29, 1995) (''[T]he Board is proposing to treat long positions in exchange-traded options the same as other registered equity securities for margin purposes.'').

[62] However, the long box spreads made up of European-style options, the margin requirements is 50% of the aggregate difference in the two exercise prices.

The proposal takes into account the defined risk of these strategies and sets margin requirements that better reflect the economic reality of each strategy. As a result, the margin requirements are tailored to the overall risk of the combined positions.

For similar reasons, the Commission approves of the proposed cash account requirements for spreads made up of European-style cash-Settled index options, stock index warrants, or currency index warrants. Under the proposal, a short position would be considered covered, and thus eligible for the cash account, if a long position in the same European-style cash-settled index option, stock index warrant, or currency index warrant was held in, or purchased for, the account on the same day. In addition, the long and short positions must expire concurrently, and the cash account must contain cash, cash equivalents, or an escrow agreement equal to at least the aggregate exercise price differential.

The Commission believes that it is reasonable for the Exchange to specify cash account requirements for certain options and warrants carried short. The proposed requirements clearly identify the criteria that must be satisfied before a short position will be deemed covered. By codifying the criteria in its margin rules, the Exchange will assist CBOE members in determining whether a short position is eligible for the cash account.

The Commission believes that is appropriate for the Exchange to revise the maintenance margin requirements for several hedging strategies that combine stock positions with options positions. The Commission recognizes that hedging strategies such as the Long Put/Long Stock, Long Call/Short Stock, Conversion, Reverse Conversion and Reverse Conversion, and Collar are designed to limit the exposure of the investor holding the combined stock and option positions. The proposal would modify the maintenance margin required for the stock component of a hedging strategy. For example, the stock component of a Long Put/Long Stock combination currently is margined without regard to the hedge provided by the long put position (*i.e.*, the 25% maintenance margin requirement for the stock component is applied in full). Under the proposal, the maintenance margin requirement for the stock component of a Long Put/Long Stock strategy would be the lesser of: (i) 10% of the put option exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (ii) 25% of the current market value of the long stock position. Although for some market values the proposed margin requirement would be the same as the current requirement, in many other cases it would be lower.[63] The Commission believes that reduced maintenance margin requirements for the stock components of hedging strategies are reasonable given the limited risk profile of the strategies.

The Commission believes that the Exchange's proposal is a carefully crafted measure that draws on the Exchange's experience in monitoring the credit exposures of options strategies. In particular, the Exchange regularly examines the coverage of options margin as it relates to price movements in the underlying securities and index components. Furthermore, many of the proposed margin requirements were thoroughly reviewed by the New York Stock Exchange (''NYSE'') Rule 431 Review Committee,[64] which is made up of industry participants who have extensive experience in margin and credit matters. Therefore, the Commission is confident that the proposed margin requirements are consistent with investor protection and properly reflect the risks of the underlying options positions.

The Commission notes that the margin requirements approved in this order are mandatory minimums. Therefore, an Exchange member may freely implement margin requirements that exceed the margin requirements adopted by the Exchange.[65] The Commission recognizes that the Exchange's margin requirements serve as non-binding benchmarks, and that Exchange members often establish different margin requirements for their customers based on a number of factors, including market volatility. The Commission encourages Exchange numbers to continue to perform independent and rigorous analyses when determining prudent levels of margin for customers.

The Commission believes that it is appropriate for the Exchange to revise Exchange Rule 12.5, ''Determination of Value for Margin Purposes.'' to allow the market value of certain long term stock options, stock index options, and stock index warrants to be considered for margin equity purposes. Under the current terms of Exchange Rule 12.5, options contracts are not deemed to have market value. Because the Exchange's proposal will allow extensions of credit on certain long term options and warrants, Exchange Rule 12.5 must be revised to permit such marginable options and warrants to be valued at current market prices for margin purposes. The Commission notes that unless Rule 12.5 is revised to recognize the market value of the marginable options and warrants, the Exchange's loan value proposal will be ineffective (*i.e.*, the market value of an appreciated marginable security would not be recognized or allowed to offset any loss in value of other securities held in the margin account).

The Commission believes that is reasonable for the Exchange to codify as part of its rules the current margin requirements for short options on securities that have been delisted due to a merger or acquisition. Under the provision, if any underlying security ceases to trade due to a merger or acquisition. Under the provision, if an underlying security ceases to trade due to a merger or acquisition, and a cash settlement price has been announced by the issuer of the option, margin would be required only for in-the-money options and would be set at 100% of the in-the-money amount. The Commission believes that it is appropriate for the Exchange to not require margin for out-of-the-money short options. Given that a fixed settlement price will have been announced by the issuer of the option (*e.g.*, Options Clearing Corporation) and trading in the delisted security will have stopped, the Commission believes that margin for the out-of-the-money short option contract is unnecessary because the intrinsic value of the option contract will not appreciate or vary such that the seller risks assignment (*i.e.*, the intrinsic value will remain nil). The Commission believes that because the intrinsic value of short-in-the-money options will similarly remain fixed, it is reasonable to require margin that corresponds to 100% of the aggregate in-the-money amount.

The Commission believes that is appropriate for the Exchange to clarify the time in which initial and maintenance margin requirements are due. This revision should help avoid confusion as to when margin payments must be made. By specifying that initial margin requirements are due in one payment period—five business days as currently defined in Regulation T—the

[63] Suppose an investor is long 100 shares of XYZ @ 52 and long 1 XYZ Jan 50 Put @ 2. Under the proposal, the required margin would be $700—the lesser of ((10% × 50) + (100% × 2) = 7) or (25% × 52 = 13). In contrast, the current margin requirement would be $1,300, a difference of $600.

[64] NYSE Rule 431 contains the margin requirements that NYSE members must observe. *See* NYSE Rule 431, ''Margin Requirements.''

[65] Exchange Rule 12.3(c), ''Customer Margin Account—Exception,'' states that nothing in the provision addressing customer margin accounts ''shall prevent a broker-dealer from requiring margin from any account in excess of the amounts specified in these provisions.

Exchange will help to facilitate the prompt collection of initial margin. In addition, the proposal revises the time-frame for the collection of maintenance margin by replacing the phrase ''within a reasonable time'' with ''as promptly as possible,'' and establishing an objective cut-off date of 15 days. The Commission believes that these changes will provide clear and definite guidelines concerning the collection of margin.

The Commission believes that it is appropriate for the Exchange to revise the definition of ''current market value'' by making it correspond to the same definition found in Regulation T. A linkage to the Regulation T definition should keep the Exchange's definition equivalent without requiring a rule filing if there are future changes to the Regulation T definition. The Commission also believes that it is reasonable for the Exchange to define ''butterfly spread'' and ''box spread.'' These definitions will specify which multiple option positions, if held together, qualify for classification as buttlerfly or box spreads, and consequently are eligible for the proposed cash and margin treatment. The Commission believes that it is important for the Exchange to clearly define which options strategies are eligible for the proposed margin treatment.

The Commission believes that it is reasonable for the Exchange to reorganize its margin provisions and consolidate them into a single section—Chapter 12 of the Exchange's Rules. As currently structured, the Exchange's margin rules are widely dispersed, appearing in Chapters 12, 23, 24, and 30. The Commission believes that Exchange members and other market participants will find the consolidated margin provisions easier to locate and use.

The Commission also believes that it is reasonable for the Exchange to rephrase and update some of the margin provisions that have been relocated and consolidated. The revisions are designed to ensure consistency among the Exchange's margin provisions. In some instances, changes proposed to one particular margin requirement impacted the requirements for other positions and products. In other instances, the Exchange simply revised language to clarify the meaning of the provision.[66] In addition, the Commission believes that it is appropriate for the Exchange to correct the misnomer in Exchange Rule 12.3(c)(1) that erroneously characterizes nonconvertible debt securities as exempted securities.

The revisions to the Exchange's margin rules will significantly impact the way Exchange members calculate margin for options customers. The Commission believes that it is important for the Exchange to be adequately prepared to implement and monitor the revised margin requirements. To best accommodate the transition, the Commission believes that a phase-in period is appropriate. Therefore, the approved margin requirements shall not become effective until the earlier of November 3, 1999 or such date the Exchange represents in writing to the Commission that the Exchange is prepared to fully implement and monitor the approved margin requirements.

The Commission expects the Exchange to issue a regulatory circular to members that discusses the revised margin provisions and provides guidance to members regarding their regulatory responsibilities. The Commission also believes that it would be helpful for the Exchange to publicly disseminate (*i.e.*, via web site posting) a summary of the most significant aspects of the new margin rules and provide clear examples of how various options positions will be margined under the new provisions.

The Commission finds good cause for approving proposed Amendment Nos. 1 and 2 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 1 clarified that the margin requirement for non-marginable options and warrants is 100% of current market value, rather than 100% of purchase price. Unless this revision was made, the margin required for some long term options that had wound down to 9 months would have been inappropriate.[67] By linking the margin requirement to current market value, rather than purchase price, Amendment No. 1 ensures that appropriate margin will be required.

Amendment No. 1 also revised the provision concerning the use of UITs and open-end mutual funds as cover for short index options. The revision conformed the Exchange's proposal to the narrower change that was recommended by the NYSE Rule 431 Committee. As a result, the Exchange's proposal limits the use of mutual funds as cover to short S&P 500 call options held in a margin or cash account.[68] Amendment No. 1 also incorporated into the proposal the definition of ''OTC margin bond,'' which had been eliminated from Regulation T by the Federal Reserve Board as of April 1, 1998. These changes will strengthen the proposal by making it consistent with the margin requirements supported by the NYSE Rule 431 Committee, and by defining an important term that was dropped from Regulation T.

Amendment No. 2 revised the proposal by limiting loan value to long term stock options, stock index options, and stock index warrants. The Exchange had originally proposed to allow loan value on any long term option, regardless of the underlying instrument (*e.g.*, foreign currency options and options on interest rate composites would be marginable): This change conforms the Exchange's proposal to the measures supported by the NYSE Rule 431 Committee and the companion margin filing submitted by the NYSE.[69] Amendment No. 2 will ensure consistency among the national securities exchanges regarding the types of securities on which credit may be extended.

Based on the above, the Commission finds that good cause exists, consistent with Section 19(b) of the Act,[70] to accelerate approval of Amendment Nos. 1 and 2 to the proposed rule change.

## V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 1 and 2 to the proposed rule change, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Copies of the submissions, all subsequent amendments, all written statements with respect to the proposed

[66] For example, the Exchange revised the rule language regarding straddles comprised of OTC options, but left intact the specific margin requirements. *See* Proposed Exchange Rule 12.3(c)(5)(C)(5)(B).

[67] For example, suppose that a long term option, which had significantly appreciated in value, reached nine months until expiration. A margin requirement of 100% of the purchase price would be insufficient given the increase in value. A requirement of 100% of the current market value, in contrast, is more appropriate.

[68] In accordance with an interpretation that the Federal Reserve Board provided to the American Stock Exchange, the Exchange will continue to permit members to use certain UITs as cover for short index option positions in a margin account. For example, the Exchange allows members to use S&P 500 Depository Receipts (''SPDRs'') as cover for short S&P 500 index options. The Federal Reserve Board deemed such practice consistent with Regulation T in 1993. *See* Letter from Michael J. Shoenfeld, Federal Reserve Board, to James McNeil, American Stock Exchange, dated February 1, 1993.

[69] *See* Securities and Exchange Act Release (No. 41168 Mar. 12, 1999), 64 FR 13620 (Mar. 19, 1999) (notice of filing of SR–NYSE–99–03).

[70] 15 U.S.C. 78s(b).

rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any persons, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 25049. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR–CBOE–97–67 and should be submitted by August 26, 1999.

## VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[71] that the proposed rule change (SR–CBOE–97–67), as amended, is approved. The approved margin requirements shall become effective the earlier of November 3, 1999 or such date the Exchange represents in writing to the Commission that the Exchange is prepared to fully implement and monitor the approved margin requirements.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[72]

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 99–20174 Filed 8–4–99; 8:45 am]

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# SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–41671: File No. SR–EMCC–99–8]**

## Self-Regulatory Organizations; Emerging Markets Clearing Corporation; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change Relating to the Extension of Interim Margin and Loss Allocation Procedures

July 29, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on June 21, 1999, the Emerging Markets Clearing Corporation (''EMCC'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I and II below, which items have been prepared primarily by EMCC. The Commission is publishing this notice and order to solicit comments from interested persons and to grant accelerated approval of the proposed rule change.

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

The proposed rule change will extend EMCC's interim margin and loss allocation procedures until the earlier of (i) September 30, 1999, or (ii) the date on which Daiwa Securities America Inc. ceases to perform clearing functions for interdealer brokers.

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

In its filing with the Commission, EMCC 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. EMCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.[2]

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

On July 31, 1998, the Commission temporarily approved EMCC's interim margin and loss allocation procedures (''Addendum G'') for a period of one year. Addendum G applies to interdealer brokers and U.S. Firms whose only business with EMCC consists of clearing for interdealer brokers.[3] The only EMCC clearing member affected by Addendum G is Daiwa Securities America Inc. (''Daiwa'').

EMCC has been advised that Daiwa intends to cease performing clearing functions for interdealer brokers by the end of September 1999. Because Addendum G expires on July 31, 1999, EMCC is requesting that the Commission extend the temporary approval of addendum G until the earlier of (i) September 30, 1999, (ii) the date on which Daiwa ceases to perform clearing functions for interdealer brokers.

EMCC believes that the proposed rule change is consistent with the requirements Section 17A of the Act[4] and the rules and regulations thereunder because extension of the temporary approval will avoid any potential disruption of EMCC's clearing services during this limited time period.

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

EMCC does not believe that the proposed rule change will impose any burden on competition.

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

No written comments relating to the proposed rule change have been solicited or received. EMCC will notify the Commission of any written comments received by EMCC.

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

Section 17A(b)(3)(F) of the Act[5] requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. In light of the fact that the Commission has previously found that Addendum G should provide EMCC with margin that is adequate to protect EMCC from financial exposure if an interdealer broker experiences financial difficulty, the Commission finds that the brief extension of the effectiveness of Addendum G is consistent with EMCC's safeguarding obligations under the Act.

EMCC has requested that the Commission find good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of the filing. The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after publication of notice because such approval will allow the protections of Addendum G to remain in effect without interruption until Daiwa ceases its interdealer clearing operations at EMCC.

### 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange

[71] 15 U.S.C. 78s(b)(2).

[72] 17 CFR 200.30–3(a)(12)

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

[2] The Commission has modified the text of the summaries prepared by EMCC.

[3] For a complete description of Addendum G, refer to Securities Exchange Act Release No. 40288 (July 31, 1998), 63 FR 42087.

[4] 15 U.S.C. 78q-1.

[5] 15 U.S.C. 78q–1(b)(3)(F)