

held in a short position to be carried in a cash account if the option is covered, i.e., if the account contains one of the specified offsets.

This provision is consistent with Regulation T and is being added so that the Amex's rule is more complete, thus enabling its members to rely on such rules for all aspects of margin regulation. The Commission believes that the proposal is a reasonable effort by the Amex to accommodate the needs of its market-makers and their customers.

Rule 462, Paragraph (d)10

The Exchange is proposing to add special margin treatment for covered write convertibles, covered calls/puts, spreads, and straddles involving OTC options. The proposed margin treatment is the same treatment that is set forth in NYSE Rule 431, except for the change to cap the minimum margin on short puts. The cap on the short puts is being adopted for the same reasons applicable to listed equity options discussed above. A chart submitted with the filing sets forth the initial and/or maintenance margin required for options on various types of underlying securities.

Given the near identical nature of the Amex's proposal to the NYSE's previously approved proposal, the Commission believes that adoption of these proposed standards is reasonable. With regard to the cap on short put positions, the Commission believes the treatment proposed by the Exchange is also reasonable for the same reasons set forth regarding the identical treatment for listed positions.

The Exchange is also proposing to add margin treatment for related securities positions involving OTC options held in a customer margin account. The proposed treatment of related securities positions in OTC options also is substantially similar to that of the NYSE and accordingly does not raise new regulatory issues.¹⁷ The Commission also believes that the Exchange's decision to model its margin treatment for OTC options and related securities positions based on the NYSE positions should help foster coordination between markets by achieving parity between the margin requirements of the various SROs.

Rule 462, Commentary .03(c)

Finally, the Exchange is proposing to change the definition of "cash equivalents" found in Commentary .03(c) and defer to the definition of Regulation T since it is expected that the definition in Regulation T will

change from time to time. The Commission believes that by adopting this approach the Exchange's definition of "cash equivalent" will remain current in accordance with Regulation T.

The Commission believes that good cause exist to approve the proposal, including Amendment Nos. 1 and 2 on accelerated basis prior to the thirtieth day after the date of publication of the notice of filing thereof. Certain provisions of Regulation T regarding option market-makers and specialists permitted offsets have been deleted as of June 1, 1997. Approval of Amex's substituting offset provisions is necessary to ensure the continued availability of these offsets. The other portions of the proposal are nearly identical to proposals submitted by the CBOE (SR-CBOE-97-17) and NYSE (SR-NYSE-97-01). Those proposals were noticed in the **Federal Register**¹⁸ with no comments received. The Commission is approving those proposals on the same date herewith. Amendment Nos. 1 and 2, which are also identical to amendments filed by the CBOE and NYSE, serve to clarify and strengthen the proposed rule filing by the Amex.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. 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-Amex-97-21 and should be submitted by July 1, 1997.

¹⁸ See Securities Exchange Act Release Nos. 38501 (April 14, 1997) 62 FR 19364 (CBOE) and, 38411 (March 17, 1997) 62 FR 14174 (NYSE).

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change (SR-Amex-97-21) is hereby approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38709; File No. SR-CBOE-97-17]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the Chicago Board Options Exchange, Incorporated and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 1 and 2 to the Proposed Rule Change Relating to Changes to Its margin Rules

June 2, 1997.

I. Introduction

On March 21, 1997, the Chicago Board Options Exchange, Incorporated ("CBOE" or the "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change seeking to amend the Exchange's margin rules.

The proposed rule change was published for comment in Securities Exchange Act Release No. 38501 (April 14, 1997), 62 FR 19364 (April 21, 1997). The CBOE submitted to the Commission Amendment No. 1 on April 15, 1997,³ and Amendment No. 2 on May 30, 1997.⁴ No comments were received on the proposal.

This order approves the proposed rule change, as amended.

II. Description of the Proposal

The CBOE proposes to make revisions to its rules governing margin that will (i)

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Timothy H. Thompson, Senior Attorney, CBOE, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation ("Market Regulation"), Commission, dated April 11, 1997 ("CBOE Amendment No. 1") making certain technical changes to the rule filing.

⁴ See Letter from Timothy H. Thompson, Senior Attorney, CBOE, to Chester McPherson, Attorney, Market Regulation, Commission, dated May 28, 1997 ("CBOE Amendment No. 2") (providing additional information and addressing certain permitted offset issues).

¹⁷ See NYSE Rule 431(f)(2).

establish CBOE rules to govern areas of margin regulation that will no longer be addressed by Regulation T ("Regulation T")⁵ of the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "Board") as of June 1, 1997, (ii) conform certain CBOE margin rules to those of the New York Stock Exchange ("NYSE"), and (iii) correct or clarify certain current provisions of the CBOE margin rules.

The Exchange proposes changes to its margin rules at this time in response to recent amendments to the Federal Reserve Board's Regulation T, the regulation that covers extensions of credit by and to brokers and dealers.⁶ Among other things, the amendments to Regulation T will modify or delete certain Board rules regarding options transactions in favor of rules to be adopted by the options exchanges, subject to approval by the Commission. The new options provisions in Regulation T became effective June 1, 1997. The Exchange also has concurrently submitted separate changes to its margin rules in another rule filing. See SR-CBOE-97-18. That second filing will be referred to herein as the "Second margin Filing." The present filing will be referred to as the "First Margin Filing."

Definition Section

The Exchange proposes adding a definition section in new paragraph (a) of Rule 12.3 "Margin Requirements." The first new definition is "current market value," which is used throughout the Rule. The Exchange is also proposing to add an interpretation to Rule 12.3 for "current market value" covering situations where there is no closing price, or where trading is halted and not reopened before the normal end of the trading day, or where the closing price is outside the last bid and offer that was established after the closing price. In such situations, the proposed interpretation to Rule 12.3 indicates that a member organization may use a reasonable estimate of the market value of the security based upon the then current bids and offers in determining the "current market value" of a security, including an option. According to the Exchange, this interpretation will allow member organizations to arrive at a more reasonable estimate of the current market value, particularly where the underlying security may be trading or quoted in other markets or in cases where the underlying security re-opens

for trading and the overlying option remains closed. The exchange also states that the new definition of "current market value" is consistent with a definition contained in New York Stock Exchange Rule 431 ("NYSE Rule 431").

The term "escrow agreement" also is being defined in new paragraph (a) of Rule 12.3. The CBOE definition requires the issuer of escrow receipts to be a U.S. bank or trust company supervised and examined by state or federal authority. The Regulation T definition allows the issuer to be a bank or any person designated as a control location under paragraph (c) of Rule 15c3-3 under the Act. The exchange is adopting a more restrictive approach because of concerns that certain control locations, such as transfer agents, are not appropriate issuers of escrow receipts and that Exchange rules should continue to limit issuers of receipts to entities such as banks, as currently set forth in Rule 24.11(d). The Exchange notes that it is continuing to study this issue.

Finally, the Exchange is revising its definition of "exempted security" by adopting the Regulation T definition.

Customer Margin Accounts

The Exchange proposes reorganizing Rule 12.3 so that all provisions concerning customer margin accounts are in the same sections of the Rule. Currently, customer margin provisions appear throughout the Rule. Under the Exchange's proposal, Rule 12.3, paragraph (b), will set forth the default margin requirements on long and short positions in customer margin accounts. Paragraph (c) will set forth the specific margin treatment for particular types of securities and positions held in customer margin accounts.

The margin treatment of "exempted securities" is proposed to be moved from current Rule 12.3, paragraph (b)(3) to new paragraph (c)(3), and amended so that it is consistent with NYSE Rule 431.⁷ Specifically, the treatment for exempted securities is being revised so that obligations of the United States (as specified in the rule) will be subject to a margin requirement of 1% to 6%, depending on the years to maturity for the obligation. Zero coupon bonds will be subject to a margin requirement of 3% for bonds with five years or more to maturity. All other exempted securities will be subject to an initial and maintenance margin requirement of 15% of the current market value or 7% of the principal amount, whichever amount is greater. Currently, Rule 12.3(b)(3) requires margin of 5% on

obligations of the United States and margin of 15% of the principal amount or 25% of the current market value of other exempted securities, whichever amount is lower.

The Exchange is also adopting a margin treatment for non-convertible debt securities which is consistent with the margin treatment in NYSE Rule 431,⁸ except that the Exchange is not adopting the special exemptions relating to mortgage related securities at this time because this provision is currently the subject of discussion by an industry committee and may be changed. The rule will require margin to be maintained equal to 20% of the current market value or 7% of the principal amount of the non-convertible debt, whichever amount is greater.

The Exchange is also proposing a new subsection to Rule 12.3 labeled "Security Offsets," which combines two current provisions from Rule 12.3 and addresses the margin treatment of short securities offset against (i) Long positions in a security exchangeable or convertible into the security held in a short position and (ii) long positions in the same security as the short position. The convertible or exchangeable provision is the same as contained in current CBOE Rule 12.3(b)(1)(A) except that an incorrect parenthetical referring to options is being deleted because options cannot be and never have been considered convertible securities. The Exchange notes that the rules of the other self-regulatory organizations ("SROs") and Regulation T do not refer to options as convertible securities. The provision dealing with offsets between long and short positions in the same security is being moved from paragraph 12.3(b)(1)(D) of current Rule 12.3 to paragraph 12.3(c), and the margin requirement is being revised from 10% to 5% of the current market value of the "long" securities to conform the CBOE rule to a similar provision in NYSE Rule 431.⁹

The Exchange is also proposing, under new paragraph (c) of Rule 12.3, which provides certain exceptions to the default margin treatment for positions in a customer margin account, new margin treatment for a short listed equity call option position offset by a warrant to purchase the underlying security. The proposed treatment is new to Rule 12.3 and is consistent with a provision of Regulation T.¹⁰ The provision requires no margin for this position if the warrant to purchase the underlying security does not expire on

⁵ 12 CFR 220.1 through 19 (1996).

⁶ See 61 FR 20386 (May 6, 1996) (Federal Reserve Board's release adopting certain changes to Regulation T).

⁷ See NYSE Rule 431(e).

⁸ *Id.*

⁹ *Id.*

¹⁰ See Regulation T, 12 CFR 220.4(b).

or before the expiration date of the short call, and if the amount (if any) by which the exercise price of the warrant exceeds the exercise price of the short call is deposited in the account.

Rule 12.3 is also being amended to clearly reflect that margin be deposited and maintained equal to 100% of the purchase price of long positions in listed equity options. This provision is consistent with current CBOE Rule 12.5, and is being added to Rule 12.3 for the sake of clarity.

Proposed Rule 12.3(c)(5), detailing the margin requirements for short listed equity options is identical to that currently found in paragraph (a)(5) of Rule 12.3, with three exceptions. First, the provision has been moved. Second, the treatment of over-the-counter ("OTC") options has been deleted from the provision because the Exchange is proposing to adopt the more extensive OTC margin provisions of the NYSE. Third, the Exchange is proposing the addition of a provision that would cap the minimum margin on short puts that are out-of-the-money at a percentage of the exercise price of the short put.

With regard to capping the required minimum margin for short listed puts, the Exchange indicates that, under the current provision, minimum margin is required equal to the option's market value plus 10% of the current market value of equivalent units of the underlying security. However, as the market value of the underlying security increases above the strike price, at some point the put becomes farther out-of-the-money and the risk of the position decreases. According to the Exchange, without the cap, the margin requirement would also continue to increase at the same time that the risk of the position is decreasing.

The Exchange is also clarifying the margin treatment of interest rate put options under Rule 23.13 and the margin treatment of put warrants under Rule 30.53. The treatment is the same as that provided for short uncovered put options as described above.

The provisions governing margin treatment for options that are offset or covered by certain defined "related securities," where such positions are carried in a customer margin account, has been revised and rearranged. These are now found under new subsection 12.3(c)(5)(B). This is necessary because various changes made over time have rendered the provisions difficult to follow. The Exchange believes that the changes being proposed will simplify the provisions and make them easier for

members to follow.¹¹ The treatment for a covered call writing position where the underlying security is a convertible security is similar to that currently described in subsection 12.3(b)(1)(C) but has been revised to be consistent with NYSE Rule 431.¹² The treatment for covered puts is similar to the treatment under current subsection 12.3(b)(1)(B); however, the language has been revised to conform to the CBOE rule to the language in Regulation T.¹³ The new language of 12.3(c)(5)(B)(2) regarding covered calls has been reworded from what currently appears in Rule 12.3(b)(1)(C)(1) to also make it consistent with Regulation T.

The treatment of short equity option contracts offset by long option contracts where the long option expires with or after the short option under current Rule 12.3(c)(1) is the same as that currently required for index options under CBOE Rule 24.11. However, the Exchange is proposing to adopt the language contained in Rule 24.11 because it is more straightforward than the language in Rule 12.3(c)(1).

The treatment for a straddle (a short call option and a short put option the same underlying interest) requires margin on the put or call, whichever amount is greater, plus the current market value of the other option. The margin treatment for straddles is merely being moved from current paragraph (a)(5) of Rule 12.3.

The rules governing the margin requirements for OTC options are based on those contained in NYSE Rule 431¹⁴ except that the Exchange has made a slight change to cap the minimum margin on OTC short puts. A chart submitted with the filing sets forth the specific initial and/or maintenance margin levels required for OTC options on various types of underlying securities.¹⁵

The Exchange is proposing to add new margin treatment provisions for OTC options positions that are covered or offset by certain "related securities" positions when such positions are held in a customer margin account and also add new margin treatment provisions for covered write convertibles, covered calls/puts, spreads, and straddles involving OTC options.¹⁶ The proposed

margin treatment is the same treatment that is set forth in NYSE Rule 431 except for a proposed change to cap the minimum margin on short puts.

Customer Cash Account

The Exchange is proposing to add a provision to Rule 12.3 detailing the circumstances under which a customer may carry short equity options in a cash account, *i.e.* an account in which no credit is extended. This provision, Rule 12.3(d), is consistent with a provision in Regulation T.¹⁷ The proposed rule would permit either a call option contract or a put option contract held in a short position to be carried in a cash account if the option contract is covered, *i.e.*, if the account contains one of the specified offsets.

In the case of a short call, allowable offsets include: (i) The underlying security, in an amount equal to or greater than that underlying the option, provided the option premium is held in the account until full cash payment for the underlying security is received; (ii) a security immediately convertible without the payment of money into an equal or greater quantity of the security underlying the option, if such security is held or purchased in the account, on the same day, and provided that the option premium is held in the account until full cash payment for the convertible security is received and the ability to convert does not expire before the expiration of the short call option; or (iii) an escrow agreement¹⁸ issued by a bank and either held in the account at the time the call is written or received in the account promptly thereafter.

In the case of a short put option, allowable offsets include: (i) Cash or cash equivalents as defined in Regulation T of not less than the aggregate put exercise amount; or (ii) an escrow agreement issued by a bank which is obligated to deliver the required cash in the event of assignment of the short put.

CBOE Rule 24.11A currently permits certain debit put spreads involving European-style broad-based stock index options to be carried in a cash account. The Exchange proposes to cross-reference the provisions of Rule 24.11A into Rule 12.3.

¹¹ Telephone conversation between Diane Malley, Supervisor, Department of Financial Compliance, CBOE, Timothy Thompson, Senior Attorney, Legal Department, CBOE, and Chester McPherson, Staff Attorney, Market Regulation, Commission, April 10, 1997.

¹² See NYSE Rule 431(f)(2)(H)(i).

¹³ See Regulation T, 12 CFR 220.4(b)(9)(iii).

¹⁴ See NYSE Rule 431(f)(2)(D)(iii).

¹⁵ See SR-CBOE-97-17, Exhibit A at 22-23.

¹⁶ See new Rule 12.3(c)(6)(B) for these provisions.

¹⁷ See Regulation T, 12 CFR 220.2.

¹⁸ The Exchange proposes to adopt the term "escrow agreement" to mean:

any agreement issued in connection with non cash settled call or put options under which a bank holding the underlying security or required cash or cash equivalents, is obligated to deliver to the creditor (in the case of a call option) or accept from the creditor (in the case of a put option) the underlying security against payment of the exercise price upon exercise of the call or put.

Market Maker and Specialist Accounts

Specific provisions governing permitted offset treatment for market-makers and specialists have been deleted from Regulation

Specific provisions governing permitted offset treatment for market-makers and specialists have been deleted from Regulation T, which now indicates that such offsets are to be determined by the rules of the applicable SRO. Accordingly, the proposed rule sets forth various permitted offset positions which may be cleared and carried by a member organization on behalf of one or more registered specialists, registered market-makers, or Designated Primary Market-Makers (hereinafter referred to generically as "market-makers") upon a margin basis satisfactory to the concerned parties. A permitted offset position will be defined to mean, in the case of an option in which a market-maker makes a market, a position in the underlying instrument or other related instrument, and in the case of other securities in which a market-maker makes a market, a position in options overlying the securities in which a market-maker makes a market, if the account holds the following positions: (i) A long position in the underlying instrument offset by a short option position which is "in- or at-the-money;" (ii) a short position in the underlying instrument offset by a long option position which is "in- or at-the-money;" (iii) a stock position resulting from the assignment of a market-maker short option position; (iv) a stock position resulting from the exercise of a market-maker long position; (v) a net long position in a security (other than an option) in which a market-maker makes a market; (vi) a net short position in a security (other than an option) in which the market-maker makes a market; or (vii) an offset position as defined in SEC Rule 15c3-1.¹⁹ All permitted offset transactions must be effected for the purpose of hedging, reducing the risk of, rebalancing, liquidating open positions of market-makers, or accommodation of customer orders, or other similar market-making purpose.

For purposes of Rule 12.3, "in- or at-the-money" means the current market price of the underlying security is not more than two standard exercise price intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option. In determining the types of instruments which are entitled to be carried in a

permitted offset position, reference can be made to the definition of "related instrument" which is set forth in the rule. "Related instrument" within an option class or product group is any related derivative product that meets the offset level requirements for product groups under Rule 15c3-1, including all appendices of the Act, or any applicable SEC staff interpretations or no-action positions (hereinafter referred to collectively as "SEC Rule 15c3-1"). The term "product group" means two or more option classes, related instruments, and qualified stock baskets for which it has been determined that a percentage of offsetting profits may be applied to losses in the determination of net capital as set forth in SEC Rule 15c3-1.

The Exchange also proposes adding a provision regarding trading in a deficit account. The provision generally states that nothing shall prohibit the carrying firm from effecting hedging transactions in the deficit account with the prior written approval of the carrying firm's SEC designated examining authority.

Broker-Dealer Account

The Exchange is also proposing to add a provision that would provide margin relief to accounts held by non-market-maker broker-dealers. Under the new provision, a member organization may carry the proprietary account of another registered broker-dealer upon a margin basis which is satisfactory to both parties, provided the requirements of Regulation T are adhered to and the account is not carried in a deficit equity condition. The amount of any deficiency between the equity maintained in the account and the margin required by the other provisions of this Rule shall be deducted in computing the net capital of the member organization under Rule 15c3-1 of the Act. This new provision is similar to the provision of NYSE Rule 431(e)(6), and would permit the proprietary accounts of all registered broker-dealers to be carried on a "good faith" margin basis for purposes of maintenance margin. Broker-dealers would still be subject to initial margin requirements under Exchange rules and Regulation T.

Interpretations to Rule 12.3

The Exchange is proposing to add four interpretations to Rule 12.3. Also, current Interpretation .01 to Rule 12.3 is proposed for deletion because the interpretation concerns SuperShares, which the Exchange no longer trades.²⁰

New Interpretation .01 sets forth in chart form the margin requirements applicable to short positions in listed options and in index and foreign currency warrants. It reflects that margin is required equal to the current market value of the option/warrant plus the applicable percentage of the underlying instrument (set forth in the chart). The margin required may be reduced by any "out-of-the-money" amount, as defined in the rule. However, the margin may not be reduced below the option market value plus the specified percentage of the current market value of the underlying instrument, as set forth in the chart. The determination of the "out-of-the-money amount" is also set forth in a separate chart.

Interpretation .02 describes how a member organization may determine "current market value" in the event there is no closing price or trading has been halted.

Interpretation .03 specifies that for purposes of the CBOE margin rules, index warrants should be treated as if they were index options unless the rules specify otherwise. The Exchange states that this interpretation recognizes that the two types of products are essentially equivalent from a market risk standpoint.

Changes to Rule 12.11

The Exchange is proposing a minor change to Rule 12.11. Rule 12.11 allows a member organization that is a member of the NYSE to elect to be bound by the rules of the NYSE instead of the requirements set forth in Rules 12.3 to 12.10. The Exchange is changing Rule 12.11 to allow the member organization to exempt themselves from Rules 12.3 to 12.9, but not from 12.10. Rule 12.10 establishes that the margin requirements set forth in the rule are minimum requirements and authorizes the Exchange to impose higher margin requirements when it deems such higher requirements to be advisable. The Exchange has determined that it is necessary to clarify that the Exchange may still impose higher margin requirements on its members when the Exchange believes such higher requirements are warranted, even when those members have elected to generally be subject to the margin rules of the NYSE. The change to Rule 12.11 also clarifies that if a member organization chooses to be bound by NYSE margin rules it will be exempt not only from CBOE margin rules in Chapter 12, but also from those margin rules in other chapters of the Exchange's rules.

¹⁹ See Securities Exchange Act Release No. 38248 (February 6, 1997) 62 FR 6474 (February 12, 1997) (Final rule adopting changes to SEC Rule 15c3-1).

²⁰ The Exchange is also proposing to delete interpretation .07 of Rule 24.11 because it also concerns SuperShares.

Changes to Rule 24.11

The Exchange is proposing to add to Rule 24.11 (which covers margin requirements for index options) a provision setting forth the margin requirements for covered calls and covered puts that is essentially identical to an existing CBOE provision applicable to equity options. In addition, the Exchange is proposing to add a definition of "qualified stock basket" to rule 24.11. This definition is used to describe allowable offsets in customer accounts for covered calls and covered puts. In addition, the Exchange makes a cross-reference to the provision of Rule 12.3 that governs the cash account treatment of short index options offset by long index options. Finally, the Exchange is proposing to change Interpretation .04 which defines "cash equivalent." Instead of specifically defining cash equivalent as it is currently defined in the rule, the Exchange has decided to defer to the definition in Regulation T because the Exchange expects that the definition in Regulation T may change from time to time.

III. Discussion

After careful review of the Exchange's proposed amendment to its margin rules, and for the reasons discussed below, the Commission believes that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges, and, in particular, with the requirements of Section 6(b) of the Act.²¹ Specifically, the Commission believes the proposal is consistent with the Section 6(b)(5) requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest.²²

Definition and Interpretation Sections

The Exchange proposes to include a definition section in Rule 12.3. The proposed definitions are: "bank," "current market value," "escrow agreement," and "exempted security."

The definition of "bank" is similar to that term as currently defined in the Act. Accordingly, the proposed

definition does not raise new or unique issues.

The proposed definition of the term "current market value" for Rule 12.3 purposes, is modelled on a similar term currently defined in Exchange Rule 24.11(a), and also includes the incorporation of certain parts of a similar definition found in NYSE Rule 431(a)(1). Accordingly, the proposed definition does not raise new or unique issues. The Exchange is also adopting an interpretation to the definition of "current market value," as discussed below.

The term "escrow agreement" being adopted by the Exchange is nearly identical to that of Regulation T except that it represents a more restrictive approach, reflecting CBOE's concern that certain control locations, such as transfer agents, are not appropriate issuers of escrow receipts. The Commission concludes that it is reasonable for the Exchange to limit the allowed issuers of escrow receipts to entities such as banks.

The Commission believes that the proposed deletion of references to SuperShares is appropriate because the product no longer trades on the Exchange. The Commission also believes that the interpretive section discussing "current market value," which is new to Rule 12.3, provides useful guidance to members, especially in circumstances where trading in a security has been halted but the OTC market is still open. As the Exchange indicates, without this guidance, members would not know what approach is acceptable to the Exchange in determining "current market value."

Other changes to the interpretation section of Rule 12.3 are discussed elsewhere in this discussion section.

Customer Margin Accounts

The Commission supports the Exchange's efforts to consolidate those rules relating to customer margin accounts into one subsection of the rule. In addition to moving and reorganizing the customer margin provisions, the Exchange also is adopting a new margin treatment for exempted securities. The proposal would generally lower the maintenance margin rates for United States debt securities from the existing 5%, and instead establish margin requirements of 1% to 6% depending on the years to maturity for the obligation. However, zero coupon bonds will be subject to a margin requirement of 3% for bonds with five years or more to maturity, and all other exempted securities, *i.e.*, other than obligation of the United States, will be subject to an initial and maintenance margin

requirement of 15% of the current market value or 7% of the principal amount, whichever is lower.

The Commission notes that the CBOE's proposed margin treatment for exempted securities is nearly identical to an existing NYSE provision. When the NYSE adopted its provision, it stated that a sliding scale would provide greater margin requirements for the more volatile long-term securities, and reduce margin requirements as government securities approach maturity to reflect the reduced risk in carrying those securities. Prior to adopting the proposal, the NYSE had also conducted an analysis of two-year historical price information for three Treasury securities of different maturities, a short-, intermediate-, and long-term instrument, and concluded that the proposed margin requirements for the more volatile long-term government instrument would provide at least a 96% confidence level that price movements over one and two week periods would be covered.²³ Accordingly, the Commission believes that the proposal by the CBOE to adopt the same margin rates for U.S. obligations as required by the NYSE is reasonable and should provide member organizations with adequate protection against adverse short-term market movements of securities in customer margin accounts. Additionally, the Commission believes uniform margin rates in this area will enhance efficiency in the market place for these securities. Nevertheless, the Commission reiterates that maintenance margin rates are intended to set a minimum margin standard and should not be construed as limiting the Exchange's ability to require margin to be deposited in excess of the minimum margin when appropriate.

The proposed treatment of non-convertible debt securities is new to Rule 12.3. The Exchange does not currently have a margin treatment specifically applicable to non-convertible debt securities and has decided to adopt the approach used by the NYSE for the sake of uniformity and because the Exchange believes that this approach is sensible. The Commission believes that this proposed revision does not raise new regulatory issues and, accordingly, is appropriate.

The proposed treatment of security offset is not new to Rule 12.3. Rather, it is a combination of two current provisions of Rule 12.3, with the deletion of an incorrect parenthetical reference to options as convertible

²¹ 15 U.S.C. § 78f(b).

²² In approving these rules, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²³ See Securities Exchange Act Release No. 24144 (February 27, 1987) 52 FR 7245 (March 9, 1987).

securities. These proposed changes are therefore reasonable and should provide clearer guidance on the treatment of security offsets.

The proposed treatment for a short listed call covered by a warrant is new to Rule 12.3 but it is substantially similar with the current treatment under Regulation T, 12 CFR 220.4(b) and, accordingly, is reasonable.

The proposed treatment for long listed equity options is new to Rule 12.3 and its provisions essentially clarify the application of Regulation T, 12 CFR 220.18(a) to such options. Specifically, the provision confirms that long listed equity options must be fully paid for at the time of purchase.²⁴

The proposed treatment for a short listed equity option has been slightly revised from the current requirements by combining existing language from the Rule 12.3²⁵ with language from Regulation T. In addition, the Exchange proposes revising the margin cap for out-of-the-money short puts. Currently, the margin requirement on a short uncovered listed equity option is calculated by adding to the option premium a percentage (20%) of the underlying instrument's value, and then subtracting any out-of-the-money amount. The Exchange also has an overriding minimum margin formula, based on a percentage (10%) of the value of the underlying instrument's market price.

According to the Exchange, the existing methods for calculating the margin treatment for short uncovered listed equity options works reasonably well, except when the overriding minimum is applied to an out-of-the-money put. Under the overriding minimum margin requirement, as a short uncovered put option becomes increasingly out-of-the-money, the margin requirement increases because the value of the underlying instrument is increasing. As a result, the CBOE indicates that margin calls may be issued for uncovered puts that are out-of-the-money. The Exchange proposes to remedy this situation by revising the method for calculating the overriding minimum margin. Specifically, the Exchange proposes to substitute the market value of the underlying instrument with a percentage of the put's aggregate exercise price. Under this new method, the minimum

requirement is a fixed value and, therefore, and increasingly higher minimum requirement will not occur as the value of the underlying rises. The Commission believes this new method for calculating the overriding minimum margin for short listed equity options is reasonable and should result in adequate margining for the affected positions.²⁶

The Exchange states that the proposed treatment of short listed equity options offset by long listed equity options where the long option expires with or after the short option under Rule 12.3 is actually the same as that currently permitted for index options under Rule 24.11. The Exchange indicates that because the treatment under its current rules for equity and index options is actually the same, adopting the more straightforward of the two treatment is a reasonable approach in that the cumbersome language of Rule 12.3 is being replaced by the easier to understand language of Rule 24.11.

The proposed treatment for a straddle (a short call option and a short put option on the same underlying interest) requires margin on the put or call, whichever amount is greater, plus 100% of the current market value of the other option. This is not a substantive change. Rather, the Exchange is merely moving the margin treatment for a straddle from current paragraph (a)(5) of Rule 12.3.

Rule 12.3(c)(6) governing the margin treatment of OTC options is new to the Exchange. It is being patterned after, and is nearly identical to the provisions contained in NYSE Rule 431(f)(2)(D)(iii). A slight difference is that the Exchange has proposed the inclusion of a cap for the minimum margin on OTC short puts for the same reasons that it proposes changing its formula for capping the margin on short listed equity options, as discussed above.

Given the near identical nature of the CBOE's proposals to the NYSE's previously approved proposal, the Commission believes that adoption of these proposed standards is reasonable. With regard to the cap on short put positions, the Commission believes such treatment is also reasonable for the same reasons set forth regarding the identical proposed treatment for listed positions.

²⁶ The Commission notes that the new minimum margin requirement should often result in higher margin levels for deep in-the-money puts. This will occur because the current minimum margin requirement for a short put is based, in part, on the underlying instrument's value, an amount that decreases as the put becomes deeper in-the-money. The new formula corrects this result by requiring a minimum margin amount based in part on the aggregate exercise value of the option, an amount that remains constant as the value of the underlying security decreases in value.

The proposed treatment of related securities positions in OTC options also is substantially similar to that of the NYSE and accordingly does not raise new regulatory issues.²⁷ The Commission also believes that the Exchange's decision to model its margin treatment for OTC options and related securities positions based on the NYSE positions should help foster coordination between markets by achieving parity between the margin requirements of the various SROs. The Commission also believes that this approach will promote coordination in regulating, clearing, settling, and facilitating transactions in securities by providing for uniformity in this area of the SROs' margin schemes and reducing confusion among customers.

Customer Cash Account

Rule 24.11A currently permits certain debit put spreads involving European-style broad-based stock index options to be carried in a cash account. The Exchange proposes to copy a certain section of 24.11A (specifically, 24.11A(f)) into Rule 12.3. Essentially, the new provision concerning debit put spreads in Rule 12.3 will serve as a cross-reference to the more detailed provisions contained in Rule 24.11A. Accordingly, although not specifically contained in the Rule 12.3 cross-reference, all of the applicable conditions contained in Rule 24.11A must be met before the described debit put spreads may be carried in a cash account.²⁸

Market Maker and Specialist Accounts

The Exchange has also proposed to adopt specific provisions governing permitted offset treatment for market-makers and specialists that are being deleted from Regulation T as of June 1, 1997. The proposed rule sets forth various permitted offset positions which may be cleared and carried by a member organization on behalf of one or more market-makers upon a margin basis satisfactory to the concerned parties ("good faith" margin). In addition, it requires that the amount of any deficiency between the equity maintained by the market-maker and the haircuts specified in SEC Rule 15c3-1 shall be considered as a deduction from net worth in the net capital computation of the carrying broker.

A permitted offset position will be defined to mean, in the case of an option in which a market-maker makes

²⁴ The Commission notes the recent amendments to Regulation T permitting SROs' rules, pursuant to SEC approval, to allow the extension of loan value to listed options. See *supra* note 6. The current proposal, however, does not address this issue or otherwise permit the extension of loan value for long listed options.

²⁵ See CBOE Rule 12.3(a)(5).

²⁷ See NYSE Rule 431(f)(2).

²⁸ See Letter from Timothy H. Thompson, Senior Attorney, CBOE, to Chester McPherson, Staff Attorney, Market Regulation Commission, dated May 30, 1997.

a market, a position in the underlying instrument or other related instrument, and in the case of other securities in which a market-maker makes a market, a position in options overlying the securities in which a market-maker makes a market, if the account holds the following positions: (i) A long position in the underlying instrument offset by a short option position which is "in- or at-the-money;" (ii) a short position in the underlying instrument offset by a long option position which is "in- or at-the-money;" (iii) a stock position resulting from the assignment of a market-maker short option position; (iv) a stock position resulting from the exercise of a market-maker long position; (v) a net long position in a security (other than an option) in which a market-maker makes a market; (vi) a net short position in a security (other than an option) in which the market-maker makes a market; or (vii) an offset position as defined in SEC Rule 15c3-1.

The six proposed offsets described in proposed Rule 12.3(f)(3)(A) (i) to (vi) codify the existing permitted offsets that were provided under Regulation T until June 1, 1997. These offsets reflect well-recognized market-making hedging transactions involving certain options offset strategies involving the related underlying stock. The addition of Rule 12.3(f)(3)(A)(vii), allowing any offset position defined under SEC Rule 15c3-1,²⁹ constitutes a significant expansion of permitted offset positions. According to the Exchange, the inclusion of item (vii) recognizes that options market-makers and specialists must engage in various hedging transactions to manage the risk involved in fulfilling their role, and, therefore, allows a member organization to clear and carry market-maker's offset positions as defined in SEC Rule 15c3-1 upon a good faith margin basis. The Exchange has clarified its proposal to reflect that market-makers are permitted to receive good faith margin for all permitted offset positions only if they are effected for market-making purposes such as hedging, reducing the risk of rebalancing, liquidating open positions of the market-maker, accommodating customer orders, or another similar market-making purpose.

The Commission believes that the proposal is a reasonable effort by the CBOE to accommodate the needs of CBOE market-makers in undertaking their market-making responsibilities as it recognizes the occasional need for market-makers to effect transactions in their course of dealing in options classes for which the market-maker is not

registered. The Commission believes that this approach will not adversely affect the depth and liquidity necessary to maintain fair and orderly markets. The Commission expects CBOE clearing firms and other CBOE members that extend margin to market-makers to implement adequate procedures to ensure that offsets elected by market-makers are recorded accurately and cleared into appropriate accounts. In addition, such members should have a reasonable basis for determining that the offset transactions satisfy the marketmaking purpose requirements set forth in CBOE Rule 12.3(f). The Commission believes that these requirements will ensure that transactions effected by market-makers and specialists receiving the offset treatment are in fact directly related to their market-making function and are not effected for speculative purposes on a margin basis which should be available only for bona fide market-making activity.

The Exchange indicates that its proposed definition of "in-or-at-the-money," for purposes of permitted offset transactions, represent a codification of its long standing practice of permitting the financing of options market-makers underlying stock positions on a good faith basis when offset on a share-for-share basis by options which are "in- or at-the-money," i.e., where the current market price of the underlying security is not more than two standard exercise price intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option (emphasis added). According to the Exchange, this practice evolved after it made changes in 1985 to its Rule 5.5 so that the interval between strike prices of options series on individual stocks is 2½ points where the strike price is greater than \$25, but less than \$200; and 10 points where the strike price is greater than \$200. The Exchange indicates that this position was represented to the Federal Reserve Board as consistent with Regulation T, 12 CFR 220.12³⁰ and that the Board has not objected to this practice.³¹ At this time, the Commission believes it is

²⁹ Regulation T, 12 CFR 220.2 defines "in- or at-the-money," to mean (until June 1, 1997) the current market price of the underlying security is not more than one (emphasis added) standard exercise interval below (with respect to a call option) or above (with respect to a put option) the exercise price of the option.

³¹ Telephone conversation between Diane Malley, Supervisor, Department of Financial Compliance, CBOE, and Chester McPherson, Staff Attorney, Market Regulation, Commission, May 28, 1997. See also Letter from Mary L. Bender, Assistant Vice President, CBOE, to Laura Homer, Federal Reserve Board, dated May 23, 1985 outlining the issue.

appropriate for the CBOE to codify this longstanding practice.

Broker-Dealer Account

The Exchange proposes adding a provision that would provide margin relief to accounts held by non-market-maker broker-dealers. Under the new provision, a member organization may carry the proprietary account of another registered broker-dealer upon a margin basis which is satisfactory to both parties, provided the requirements of Regulation T are adhered to and the account is not carried in a deficit equity condition. This new provision is substantially similar to the provision of NYSE Rule. 431(e)(6) and is being adopted by the Exchange for the sake of uniformity. Accordingly, this change is appropriate.

Changes to Rule 12.11

The Exchange has determined to allow its members who are also members of the NYSE to exempt themselves from CBOE Rules 12.3 to 12.9. However, the Exchange has determined to not allow its members to exempt themselves from CBOE Rule 12.10. Rule 12.10 authorizes the Exchange to impose higher margin requirements when it deems such higher requirements to be advisable. The Commission agrees that it is reasonable for the CBOE to be able to determine when higher margin requirements will be required for positions in Exchange-traded products and that, therefore, its members should not be permitted to exempt themselves from this rule. The Commission notes that the Exchange is under no obligation to allow its members to be exempted from any of its applicable rules unless the Exchange believes such exemption is appropriate.

Changes to Rule 24.11

The addition of this section is intended to provide the same margin cover for covered calls and covered puts involving index options³² as is currently allowed for equity options. The recent amendments to Regulation T include a new provision that allows SROs, subject to SEC approval, to expand the allowed types of covered transactions (in addition to those allowed under the Regulation T definition of covered transactions), provided that: (i) The position has finite

³² The current proposal only addresses index options that are covered by a "qualified portfolio" containing all of the stocks represented in the index, in proportion to their representation in the index. Provisions for short index options offset by long index options are proposed in the Second Margin Filing.

²⁹ See *supra* note 19.

risk; (ii) the amount at risk is held in the account in cash, cash equivalents, or via an escrow agreement; and (iii) the transaction is eligible for the cash account. The existing covered transaction provisions of Regulation T do not address positions involving index options. The Commission has addressed this area in the past by granting a number of no-action positions that allow certain short index call option positions to be offset by a portfolio of stocks that exactly replicates the index option.³² The proposed revision to Rule 24.11 essentially codifies the margin treatment permitted under these prior positions and therefore is appropriate. Although these prior no-action positions did not address or grant no-action relief to short index put options offset by short positions in a portfolio of stocks replicating the index option, the Commission concludes that such positions nonetheless satisfy the noted regulatory standards required for covered transactions and such treatment is consistent with the covered treatment afforded to transactions in equity options. Accordingly, this provision is reasonable and appropriate.

Accelerated Approval of Amendment Nos. 1 and 2

The Commission finds good cause for approving Amendment Nos. 1 and 2 period to the thirtieth day after the date of publication of notice of filing thereof. Amendment No. 1 addresses technical changes by making corrections to certain typographical mistakes appearing in the rule filing. Amendment No. 2 also makes technical changes by correcting an incorrect cross-reference in CBOE Rule 12.5 and other inadvertent omissions. In addition, it addresses a number of substantive issues, including limiting the availability of good faith margin for permitted offset to only bona fide market-making transactions. Amendment No. 2 also addresses the margin treatment applicable to long listed equity options. Instead of requiring margin to be equal to the current market value of long listed equity options, the requirement has been changed to equal at least the purchase price of the option. This change better reflects the purpose of the proposed change, which was to confirm that long listed options must be paid for in full at the time of purchase. The

originally proposed language could possibly be interpreted to impose a maintenance margin requirement for such positions, which is not required for fully paid long positions. The remainder of Amendment No. 2 merely provided additional information regarding issues that were adequately published through the notice of this proposed rule filing. All of the amended changes strengthen and clarify the proposal. Based on the above, the Commission finds that there exists good cause consistent with Section 6(b)(5) of the Act, to accelerated approval of the amendments.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 1 and 2. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of all such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to the file number SR-CBOE-97-17 and should be submitted by June 23, 1997.

It is therefore Ordered, pursuant to Section 19(b)(2) of the Act,³⁴ that the proposed rule change (SR-CBOE-97-17) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁵

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38708; File No. SR-NYSE-97-01]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the New York Stock Exchange, Incorporated Regarding Changes in its Margin Rules

June 2, 1997.

I. Introduction

On January 9, 1997, the New York Stock Exchange, Incorporated ("NYSE" or the "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend certain sections of the Exchange's rules to comply with changes to Regulation T which became effective June 1, 1997.

The proposed rule change was published for comment in Securities Exchange Act Release No. 38411 (March 17, 1997), 62 FR 14174 (March 25, 1997). The NYSE submitted a written clarification regarding its filing to the Commission on May 29, 1997.³ No comments were received on the proposal.

This order approves the proposed rule change.

II. Description of the Proposal

The NYSE proposes to make revisions to its rules governing margin that will establish NYSE rules to govern areas of margin regulation that will no longer be addressed by Regulation T ("Regulation T")⁴ of the Board of Governors of the Federal Reserve System ("Federal Reserve Board," "FRB" or "Board"). The Federal Reserve System's Regulation T, which covers the extensions of credit by and to brokers and dealers, currently prescribes margin requirements for options transactions. In April 1996, the Federal Reserve Board amended Regulation T to delete certain rules regarding options transactions in favor of rules to be adopted by the options exchanges and approved by the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Donald van Weezel, Managing Director, Regulatory Affairs, NYSE, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation ("Market Regulation"), Commission, dated May 29, 1997, clarifying requirement relating to the proposed permitted market-maker offset provisions.

⁴ 12 CFR 220.1 through 19 (1996).

³² See, e.g., Letter from Sharon Lawson, Senior Special Counsel, Market Regulation, to Diane Malley, CBOE, dated October 4, 1996 (short index call positions in Goldman Sachs Technology Composite Index and Goldman Sachs Technology sub-Index options).

³⁴ 15 U.S.C. 78s(b)(2).

³⁵ 17 CFR 200.30-3(a)(12).