



Regulatory Circular RG06-128

Date: December 15, 2006

To: Members and Member Organizations

From: Division of Regulatory Services

Subject: Margin Requirements, Expansion and Revisions of Rules
Related to Portfolio Margining of Customer Accounts

Exchange
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KEY POINTS

- On December 12, 2006, the Securities and Exchange Commission ("SEC") approved amendments to CBOE rules covering portfolio margining of customer accounts.¹ The effective date of the amendments is **April 2, 2007**.
- The amendments expand the types of instruments that are eligible for portfolio margin treatment and modify the rules in a number of aspects.² The New York Stock Exchange, which is the Designated Examining Authority for most CBOE member firms, submitted similar rules that have also been approved.
- A rule has been added that requires a member organization to notify and receive approval from its Designated Examining Authority ("DEA") prior to implementing a portfolio margining methodology for customers.
- Like the previous rules, member organizations are required to establish and maintain written procedures for monitoring the risk of portfolio margin accounts. An amendment requires that the written procedures be filed with a member organization's DEA and submitted to the SEC.³ Therefore, the DEA will consider approval of implementation only if the written procedures, and all relevant supporting documentation, have been filed with the DEA.

¹ Securities Exchange Act Release No. 54919 (December 12, 2006). (SR-CBOE-2006-14).

² However, cross-margining is still not operative because of a lack of exemptive relief needed from futures regulatory authorities.

³ Previously, it was required that the written procedures be filed with the CBOE rather than the DEA. There was no requirement to submit them to the SEC.

- A member organization for which the CBOE is the DEA may file requests to implement portfolio margining (along with the requisite written procedures for risk monitoring) with James Adams in the Exchange's Department of Member Firm Regulation.

DISCUSSION

On December 12, 2006, the SEC approved amendments to CBOE rules governing portfolio margining of customer accounts⁴. The effective date of the amendments is **April 2, 2007**. The amendments:

- expand the scope of products eligible for portfolio margining to include equities, equity options, narrow-based index options, security futures products and unlisted derivatives, whereas previously only broad-based index options and related products were permitted,
- eliminate the five million dollar minimum account equity requirement, except for portfolio margin accounts that carry unlisted derivatives,
- provide that cross-margining can be conducted in a portfolio margin account instead of a separate cross-margin account as previously required,
- eliminate the requirement to transfer fully paid for long positions out of the portfolio margin account when they are the only positions in the account,
- in the case of a broad-based index option, removes the prohibition on having an unhedged position in a related exchange traded fund (and imposes no hedging requirement on positions in equity securities),
- require a margin deficiency to be resolved within three business days instead of within one business day under the previous rule,
- require a member organization to deduct from net capital the amount of any margin deficiency in each portfolio margin customer's account beginning on the business day after the deficiency is created,
- provide that a member organization should not permit a customer to make a practice of meeting portfolio margin deficiencies by liquidation whereas under the previous rule portfolio margin accounts were excepted,⁵

⁴ CBOE Rules 12.4 – Portfolio Margin and Cross-Margin for Index Options, 13.5 – Customer Portfolio Margin Accounts (net capital), and 15.8A – Risk Analysis of Portfolio Margin Accounts, as well as Rule 9.15(c), which concerns the format of a written risk disclosure statement.

⁵ It is left to the member organization to decide how many liquidations constitute a practice.

- provide that accounts with at least five million dollars in equity are not subject to the Exchange's day trading rule whereas under the previous rule any portfolio margin account was,
- prohibit portfolio margin accounts with less than five million dollars in equity from purposefully engaging in a strategy of day trading, but permits day trading if the position day traded was part of a hedge strategy.

Margin Calculation

Positions are allocated to separate portfolios according to underlying security. As with the previous rule, a margin requirement is computed by "stressing" a portfolio at ten equidistant intervals (valuation points) representing assumed market moves, both up and down, in the current value of the underlying security or index. Gains and losses at each valuation point are netted and the greatest net loss among the valuation points is the margin requirement for that portfolio. The total margin requirement is the sum of the margin requirements for each portfolio. For equities, equity options, narrow-based indices and security futures products, the amendments require assumed up/down moves of +/-15% as the end points. For broad-based index portfolios, the assumed up/down moves remain the same (-8%/+6% for high capitalization indices; +/-10% for non-high capitalization indices).

Written Disclosure Statement

The rules continue to require that a member organization provide portfolio margin customers with a written disclosure statement describing the nature and risks of portfolio margining. Rule 9.15(c) requires that the disclosure statement be in a format prescribed by the Exchange, but also allows a member organization to develop its own format provided it is substantially similar to the Exchange's format and receives prior approval of the Exchange. Rule 9.15(c) has been amended to remove a sample disclosure statement included under the rule. Instead, the Exchange will be publishing a prescribed format in a Regulatory Circular.

Approval to Implement Portfolio Margining

As noted above (page 1), the DEA will consider requests for approval of implementation only if the written procedures, and all relevant supporting documentation, have been filed with the DEA. Rule 15.8A has been amended to require several additional elements in a member organization's risk analysis procedures. In addition to the measures specifically required in Rule 15.8A, the procedures must be fully documented and should address, at minimum, the following:

- Opening of portfolio margin accounts;
- The profile of customers who will be eligible for portfolio margining, including the initial approval process to be applied by the firm;
- A description of minimum equity requirements for each customer;

- The determination, review and approval of credit limits for each customer and across all customers;
- A description of any internal model used to determine risk in individual customer accounts, including the documentation for such model;
- A description of correlation assumptions included in any internal models used for assessing the adequacy of margin in a customer's account;
- A description of the stress testing methodologies applied to the accounts, the frequency of such testing and the results of the most recent stress test;
- Monitoring of accounts to assess if the account contains a portfolio of hedged instruments;
- Identification of security concentrations within an account;
- Identification of concentrations across customer accounts;
- Intra-day monitoring of credit exposure in customer accounts;
- Monitoring of day trading requirements;
- Monitoring of limitation on credit extended on portfolio margin accounts to 1,000 percent of the member organization's net capital;
- A description of the process for obtaining the theoretical values and the process used to compute margin requirements in individual customer accounts;
- A description of house margin requirements if they differ from the Exchange requirement
- A description of exception reports that will be utilized to monitor margin exposure;
- A description of the escalation procedures to alert senior management of unusual risks;
- The review and testing of the risk analysis procedures by an independent party (e.g., internal audit, external auditors, etc.); and
- An organization chart identifying those persons primarily responsible for risk management of portfolio margin accounts and the person or persons to whom they report.

Questions concerning portfolio margining may be directed to James Adams, (312) 786-7718, in the Exchange's Department of Member Firm Regulation.