SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54125; File No. SR-NYSE-2005-93)

July 11, 2006

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving a Proposed Rule Change to Rule 431 ("Margin Requirements") and Rule 726 ("Delivery of Options Disclosure Document and Prospectus") to Expand the Products Eligible for Customer Portfolio Margining and Cross-Margining Pilot Program

I. Introduction

On December 29, 2005, the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")[1] and Rule 19b-4[2] thereunder, a proposed rule change seeking to amend NYSE Rules 431 and 726 to expand the scope of products that are eligible for treatment as part of the Commission's approved portfolio margin pilot program (the "Pilot").[3] The NYSE seeks to expand the list of eligible products in the Pilot to include security futures contracts[4] and listed single stock options. The proposed rule change was published in the Federal Register on Monday, January 23, 2006.[5] The Commission received three comment letters in response to the Federal Register notice.[6]

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

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 52031 (July 14, 2005), 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19). On July 14, 2005, the Commission approved on a Pilot Basis expiring July 31, 2007, amendments to Exchange Rule 431 to permit the use of a prescribed risk-based margin requirement ("portfolio margin") for certain specified products as an alternative to the strategy based margin requirements currently required in section (a) through (f) of the Rule. Amendments to Rule 726 were also approved to require disclosure to, and written acknowledgment from, customers in connection with the use of portfolio margin.

The comment letters and the Exchange's responses to the comments[7] are summarized below. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

a. Summary of Proposed Rule Change

The proposed rule change consists of amendments to NYSE Rule 431 to include listed security futures and listed single stock options as eligible products for customer

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See also NYSE Information Memo 05-56, dated August 18, 2005 for additional information.

4 For purposes of the proposed rule change, term "security futures" utilizes the definition at Section 3(a)(55) of the Exchange Act, excluding narrow-based security indexes.

5 See Exchange Act Release No. 53126 (Jan. 13, 2006), 71 FR 3586 (Jan. 23, 2006).

6 See letter from Gerard J. Quinn, Vice President and Associate General Counsel, Securities Industry Association, to Nancy M. Morris, Secretary, Commission, dated February 13, 2006 ("SIA Letter"); letter from Barbara Wierzynski, Executive Vice President and General Counsel, Futures Industry Association, to Nancy M. Morris, Secretary, Commission, dated February 13, 2006 ("FIA Letter"); and letter from Severino Renna, Director, Citigroup Global Markets, Inc., to Nancy M. Morris, Secretary, dated February 13, 2006 ("Citigroup Letter").

7 See letter from Mary Yeager, Assistant Secretary, NYSE, to Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, dated June 2, 2006 ("NYSE Response").

portfolio margining under the Pilot.[8] The proposed rule change also includes amendments to NYSE Rule 726 to conform the required customer disclosure to the changes made in the proposed rule change, including the expansion of eligible products.

Section 7(a)[9] of the Exchange Act[10] empowers the Board of Governors of the Federal Reserve System ("Federal Reserve Board") to prescribe rules and regulations regarding credit that broker-dealers can extend to their customers on securities transactions. Pursuant to this authority, the Federal Reserve Board adopted Regulation T.[11] The Federal Reserve Board, in the 1998 amendments, removed from the scope of Regulation T transactions governed by a portfolio margin rule approved by the Commission.[12] The Commodity Futures Modernization Act of 2000 ("CFMA") authorized the trading of futures on individual stocks and narrow-based stock indexes, i.e., securities futures products.[13] Under the CFMA, the Federal Reserve Board has

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[8] The list of eligible products under the Pilot currently includes listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds. The NYSE also has filed an additional rule change to, among other things, further expand the list of eligible products for the Pilot to include equities and unlisted derivatives. See Exchange Act Release No. 53577 (March 30, 2006), 71 FR 17536 (April 6, 2006) (SR-NYSE-2006-13); see also Exchange Act Release No. 53576 (March 30, 2006), 71 FR 17519 (April 6, 2006) (SR-CBOE-2006-14). The comment period for these proposed rule filings ended on May 11, 2006.

[9] 15 U.S.C. 78g.

[10] 15 U.S.C. 78a et seq.

[11] 12 CFR 220.1 et seq.

[12] See Federal Reserve System, "Securities Credit Transactions; Borrowing by Brokers and Dealers"; Regulations G, T, U and X; Docket Nos. R-0905, R-0923 and R-0944, 63 FR 2806 (January 16, 1998).

[13] Pub. L. No. 106-554, 114 Stat. 2763 (2000).

authority to either issue margin rules for securities futures or delegate joint authority to the Commission and the Commodity Futures Trading Commission ("CFTC") to issue such rules. The Federal Reserve Board delegated authority to the Commission and CFTC, and in 2002 the Commission and the CFTC jointly issued margin requirements for securities futures products.[14] The jointly issued rules exempted from their scope transactions in securities futures products subject to SRO portfolio margin rules.[15]

NYSE Rule 431 prescribes specific margin requirements for customers based on the type of securities products held in their accounts. In April 1996, the Exchange established the Rule 431 Committee (the "Committee") to assess the adequacy of Rule 431 on an ongoing basis, review margin requirements and make recommendations for change. The Exchange's Board of Directors has approved a number of proposed amendments resulting from the Committee's recommendations since the Committee was established.[16] The NYSE noted in its rule proposal that the Committee endorsed the proposed rule change discussed below.

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[14] Exchange Act Release 46292 (Aug. 1, 2002), 67 FR 53146 (Aug. 14, 2002).

[15] 17 CFR 242.400(c)(2).

[16] The Committee is composed of several member organizations, including Goldman, Sachs & Co., Morgan Stanley & Co., Inc., Merrill Lynch, Pierce, Fenner and Smith, Inc., Bear Stearns Corp. and Credit Suisse First Boston Corp. and several self-regulatory organizations, including: the NYSE, the Chicago Board Options Exchange, the Options Clearing Corporation ("OCC"), the American Stock Exchange, the Chicago Board of Trade, the Chicago Mercantile Exchange, and theNational Association of Securities Dealers.

b. Portfolio Margining

Portfolio margining is a methodology for calculating a customer's margin requirement by "shocking" a portfolio of financial instruments at different equidistant points along a range representing a potential percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. For example, the calculation points could be spread equidistantly along a range bounded on one end by a 15% increase in market value of the instrument and at the other end by a 15% decrease in market value. Gains and losses for each instrument in the portfolio are netted at each calculation point along the range to derive a potential portfolio-wide gain or loss for the point. The margin requirement is the amount of the greatest portfolio-wide loss among the calculation points.

Under the Exchange's proposed rule, the range of products eligible for portfolio margining would be expanded from securities and futures based on broad-based U.S. securities indexes (e.g., the S&P 500 or S&P 100)) to include security futures products and listed single stock options. The gain or loss on each position in the portfolio is calculated at each of 10 equidistant points ("valuation points") set at and between the upper and lower market range points. Under the current rule, the range for non-high capitalization indexes is between a market increase of 10% and a decrease of 10%. The range for high capitalization indexes is between a market increase of 6% and a decrease of 8%.[17] The range for portfolios of securities futures products and single stock options under the proposed rule change would be a market increase of 15% and a decrease of 15% (i.e., the valuation points would be +/- 3%, 6%, 9%, 12%, and 15%).[18] As with the current Pilot, a theoretical options pricing model would be used to derive position values at each valuation point for the purpose of determining the gain or loss.[19]

The amount of margin (initial and maintenance) required with respect to a given portfolio would be the larger of: (1) the greatest loss amount among the valuation point calculations; or (2) the sum of $.375 for each option and future in the portfolio multiplied by the contract's or instrument's multiplier. The second computation establishes a minimum margin requirement to ensure that a certain level of margin is required from the customer in the event the greatest loss among the valuation points is de minimis.

Finally, under the proposed rule change, member organizations would need to notify and receive approval from the Exchange prior to establishing a portfolio margin program for eligible customers.

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17 These are the same ranges applied to options market makers under Appendix A to Rule 15c3-1 (17 CFR 240.15c3-1a), which permits a broker-dealer when computing net capital to calculate securities haircuts on options and related positions using a portfolio margin methodology. See 17 CFR 240.15c3-1a(b)(1)(iv)(A); see also Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000).

18 This range also is consistent with Rule 15c3-1a. See supra note 17.

19 The pricing model would need to meet the requirements in Rule 15c3-1a. Currently, the only model that qualifies under Rule 15c3-1a is the OCC's Theoretical Intermarket Margining System (TIMS).

c. Margin Deficiency

The proposed amendments would require a member organization to deduct from its net capital the amount of any portfolio margin maintenance call not met by the close of business of trade date plus one day (T+1). This condition would be different from the current requirement of T+3 and would apply to margin calls related to portfolios of all eligible products. NYSE member organizations would not be permitted to deduct any portfolio margin maintenance call amount from net capital in lieu of collecting the required margin from the customer.

d. Waiver of $5.0 Million Equity Requirement

The proposed amendments would permit customers that are not broker-dealers or members of a national futures exchange to effect transactions solely in security futures and listed single stock options without maintaining $5.0 million in equity as required under the Pilot for broad-based securities index products.[20]

e. Risk Disclosure Statement and Acknowledgement

The Pilot requires a broker-dealer to provide a portfolio margin customer with a written risk disclosure statement at or prior to the initial opening of a portfolio margin account. This disclosure statement highlights the risks and describes the operation of a portfolio margin account. The disclosure statement also describes, among other things, eligibility requirements for opening a portfolio margin account, the instruments that are allowed in the account, and when deposits to meet margin and minimum equity requirements are due. Further, at or prior to the time a portfolio margin account is

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[20] See proposed rule 431(g)(9)(A).

initially opened, the broker-dealer is required to obtain a signed acknowledgement concerning portfolio margining from the customer. Under the current Pilot, a separate acknowledgement is required for cross-margining.[21]

The proposed rule change amends the disclosure requirements under Rule 726 to incorporate the expanded list of eligible products in the Pilot and other changes contained in the proposed rule change.

III. Summary of Comments Received and NYSE Response

The Commission received a total of three comment letters to the proposed rule change.[22] The comments, in general, were supportive. One commenter stated that it "is strongly supportive of the NYSE's efforts to incorporate portfolio margining into Rule 431 and hopes the Commission will speedily approve amendments to Rule 431 to increase the scope of portfolio margining."[23] Each commenter, however, recommended changes to specific provisions of the proposed rule change.

Two of the commenters stated that the list of eligible products should be expanded under the Pilot to include a broader range of assets including all listed and OTC equity securities.[24] Three commenters stated that operational and legal issues make it difficult to have separate accounts for portfolio margining and cross margining as

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21 "Cross-margining" refers to the inclusion of futures that are not securities in a portfolio as is permitted under the current Pilot for portfolios of broad-based securities index products.

22 See supra note 6.

23 See SIA Letter.

24 See SIA Letter and Citigroup Letter.

required under the Pilot.[25] One commenter suggested that the Pilot should allow for portfolio margining to be done through a single account, rather than requiring that cross-margining be done through a separate account.[26] The NYSE's subsequent rule filing responds to these comments through further proposed amendments.[27] Specifically, in that expanded filing, the Exchange proposed eliminating the cross margin account and expanding the types of eligible products that can be included in a portfolio margin account.[28] In its response to comments, the Exchange also encouraged the Commission to adopt this subsequent proposed rule filing.[29]

One commenter stated that the multiplier of $.375 should be changed to $.25 per contract to be more consistent with Appendix A to Rule 15c3-1.[30] The Exchange noted that it is concerned about the amount of potential leverage that can be created at each broker-dealer and believes that the higher minimum requirement would serve as an added cushion in the event of a severe market movement. Even though positions in the account are hedged, the Exchange noted that it is concerned about potential illiquidity in the

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25 See SIA Letter; Citigroup Letter; and FIA Letter.

26 See SIA Letter.

27 See SR-NYSE-2006-13 (proposal to expand list of eligible products in the Pilot and eliminate the separate cross-margin account). See supra note 8.

28 Id.

29 Id.; see also NYSE Response.

30 See SIA Letter. 17 CFR 240.15c3-1a.

market that could create sizeable gap risk in the event that both sides of a hedge cannot be closed out at the same time.[31]

One commenter also suggested that sophisticated member firms should be able to utilize proprietary models to estimate potential losses in determining portfolio margin requirements.[32] In response to this comment, the Exchange stated that it would like to gain additional experience with the use of such risk models before it could permit its member organizations to utilize these models for margining purposes.[33]

Finally, the Exchange stated that it will continue to work with the Commission staff and respective industry committees to address future enhancements to portfolio margining.[34]

IV. Discussion and Commission Findings

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[35] In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,[36] in that it is designed to perfect

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31 See NYSE Response.

32 See Citigroup Letter.

33 See NYSE Response.

34 See NYSE Response.

35 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

36 15 U.S.C. 78f(b)(5).

the mechanism of a free and open market and to protect investors and the public interest. The Commission notes that that the proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency with respect to Exchange margin requirements and will better align margin requirements with the actual risk of hedged positions. Moreover, the Commission notes that approving the proposed rule change would be consistent with the Federal Reserve Board's 1998 amendments to Regulation T, which sought to advance the use of portfolio margining.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[37] that the proposed rule change (File No. SR-NYSE-2005-93), is approved on a pilot basis to expire on July 31, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[38]

Nancy M. Morris
Secretary

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[37] 15 U.S.C. 78s(b)(2).

[38] 17 CFR 200.30-3(a)(12).