CBOE
CHICAGO BOARD OPTIONS EXCHANGE

Regulatory Circular RG05-71

To: The Membership

From: Division of Regulatory Services

Date: August 31, 2005

Subject: Broad-Based Index Portfolio Margin Program for Certain Customers

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KEY POINTS

- On July 14, 2005, the Securities and Exchange Commission (the "SEC" or "Commission") approved rule filings by the Chicago Board Options Exchange (the "CBOE" or "Exchange") and New York Stock Exchange that permit member organizations to compute a margin requirement for broad-based index options and related exchange traded funds of certain customers using a portfolio (risk-based) methodology.

- With the exception of a broker-dealer customer or member of a national futures exchange,[1] a customer must have or establish, and maintain, equity of not less than five million dollars across one or more accounts with the member organization in order to open a portfolio margin and/or a cross-margin account (see 4th bullet below). Member organizations may combine all accounts (including futures accounts) carried for the same customer in identical ownership name for the purpose of meeting the minimum equity requirement.

- Only the theoretical option prices supplied by The Options Clearing Corporation ("OCC") may be used by member organizations for computing gains and losses on option positions used to produce the portfolio margin requirement. The customer portfolio margin program utilizes the same framework now used by member organizations to compute risk-based capital charges (haircuts) and the data are obtained from the OCC in the same manner.

- For member organizations that are also futures commission merchants ("FCM"),[2] the approved rules also provide for a separate customer cross-margin account in which

[1] The five million dollar minimum account equity requirement does not apply to cross-margining of a member of a national futures exchange provided the member is hedging its index futures / options positions with securities index options.

[2] In addition to being an FCM, member organizations must be a clearing member of a futures clearing organization or have an affiliate that is a clearing member of a futures clearing organization. If a member

broad-based index futures and options on such futures can be combined with corresponding securities index options and exchange traded funds, and for a margin requirement to be computed by applying the portfolio margin methodology.

- However, a cross-margin account must be carried as a securities account, and until such time as relief is granted by the Commodity Futures Trading Commission ("CFTC"), member organizations must comply with the customer protection requirements of both the SEC and CFTC in respect of futures and options on futures carried in a customer cross-margin account.

- Clearing members that wish to take advantage of customer portfolio margin and/or cross-margin at the clearing house level should contact The Options Clearing Corporation.

DISCUSSION

The broad-based index portfolio margin program for certain customer is codified under new Rule 12.4 – Portfolio Margin and Cross-Margin for Index Options.

The rule specifies which instruments are eligible for the portfolio margin and cross-margin accounts, market ranges for computing the margin requirement, which persons are eligible to participate, requirements for opening a portfolio margin or cross-margin account, the manner in which a margin requirement is to be computed and actions required in the event of a deficiency in the required margin or the required minimum account equity.

As noted above, a customer must have and maintain a minimum account equity in order to be eligible for portfolio margining.

On or before the date of an initial transaction in a portfolio margin account, a customer must be provided with a special written disclosure statement describing the nature and risks of portfolio margining and cross-margining, and the customer must sign and return an acknowledgement form. If a cross-margin account is opened, there is a separate acknowledgement form that must also be returned.

Generally, the rules prohibit an underlying instrument (i.e., an exchange traded fund) from being carried in a portfolio margin or cross-margin account, or futures / options on futures from being carried in a cross-margin account, unless there is an offsetting position.

The portfolio margin requirement is both an initial and maintenance margin requirement. Guarantees by any other account for purposes of margin requirements are not permitted. There will be a minimum margin requirement of $.375 for each listed option contract and related instrument multiplied by the contract or instrument's multiplier, not to exceed the market value in the case of long positions in listed options and options on futures contracts.

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organization has a customer omnibus relationship with another broker-dealer, that broker-dealer must meet the foregoing requirements.

If at any time, the equity in a portfolio margin or cross-margin account is less than the margin required, the member organization must obtain sufficient margin to cover the deficit within one business day (T+1).

Member organizations are required under new Exchange Rule 13.5 – Customer Portfolio Margin Accounts, to limit gross customer portfolio margin requirements, including margin required in cross-margin accounts, to not more than 10 times net capital.

Member organizations are also required under new Exchange Rule 15.8A – Risk Analysis of Portfolio Margin Accounts, to establish and maintain written procedures for assessing and monitoring the potential risk to the member organization's capital in connection with its customer portfolio margin and cross-margin accounts.

A more detailed summary of the portfolio margin and cross-margin rules is available. A copy may be requested from, and any questions concerning portfolio margin and cross-margin accounts should be directed to, James Adams at (312) 786–7718. The summary may also be found at the following web site:

www.cboe.com/Institutional/Margin.aspx#changes