

## 2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,<sup>9</sup> which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. Specifically, the NASD believes that, by assisting the NASD in ensuring employee compliance with NASD ethical standards, the proposed rule change serves the public interest.

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

NASD Regulation does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

NASD Regulation did not solicit or receive written comments on the proposed rule change.

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

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 Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 Room. 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-NASD-00-58 and should be submitted by December 19, 2000.

<sup>9</sup> 15 U.S.C. 78o(b)(6).

## IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association,<sup>10</sup> and in particular, the requirements of section 15A(b)(6)<sup>11</sup> of the Act, because it is designed to foster cooperation and coordination with persons engaged in processing information with respect to securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The proposed rule change is based upon recommendations made by SEC staff to the SROs. The amendments to the rules are designed to promote a high level of professional and personal ethical conduct by NASD members and employees and to ensure that NASD members and employees do not place their own personal and financial interests above the regulatory interests of the NASD. The proposal also helps to bring the NASD's conflict of interest and ethical conduct provisions in line with those of the NASD Code of Conduct and the Amex (a subsidiary of the NASD) and helps eliminate any confusion regarding the application of these provisions to employees of both self-regulatory organizations.

The Commission finds good cause for approving the proposed rule change (SR-NASD-00-58) prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. The Commission approved a proposal by the Amex to adopt Amex Rule 417, which is virtually identical to new NASD Rule 3090.<sup>12</sup>

*It Is Therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>13</sup> that the proposed rule change (SR-NASD-00-58) is hereby approved on an accelerated basis.

<sup>10</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78o-3(b)(6).

<sup>12</sup> See Securities Exchange Act Release No. 43587 (November 17, 2000) (Order approving SR-Amex-00-23).

<sup>13</sup> 15 U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>14</sup>

**Jonathan G. Katz,**  
*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43581; File No. SR-NASD-00-15]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment Nos. 1 and 2 to the Proposed Rule Change Relating to NASD Rule 2520, "Margin Requirements"

November 17, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 31, 2000, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission"), the proposed rule change as described in Items I and II below, which Items have been prepared by NASD Regulation. NASD Regulation amended its proposal on July 31, 2000, and September 13, 2000.<sup>3</sup> The

<sup>14</sup> 17 CFR 200.30-3(a)(12).

<sup>15</sup> U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Jack Drogin, Assistant Director, Division of Market Regulation ("Division"), Commission, dated July 28, 2000 ("Amendment No. 1"); and see letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Jack Drogin, Assistant Director, Division, dated September 11, 2000 ("Amendment No. 2"). Among other things, Amendment No. 1 revises the proposal to: (1) Provide technical corrections for various provisions within NASD Rules 2520 and 2522; (2) revise the cash account provisions of NASD Rule 2520(f)(2)(M)(i) to indicate that a long warrant or option that is not listed must be guaranteed by the carrying broker-dealer to serve as an offset for a short position, or the short position will not be eligible for the cash account and must be margined separately pursuant to NASD Rule 2520(f)(2)(D); (3) amend NASD Rule 2520(f)(2) to provide that the margin for a long over-the-counter ("OTC") option or warrant with over nine months until expiration will be 75% of the option's or warrant's in-the-money amount; (4) amend NASD Rules 2520(f)(2)(D)(i) and 2520(f)(2)(G)(v) to clarify that the minimum amount of margin that must be maintained on certain positions is a percentage of the aggregate exercise price; (5) provide definitions of "stock index warrant" and "escrow agreement" in connection with cash-settled options or warrants;

Commission is publishing this notice to solicit comments on the proposed rule change and Amendment Nos. 1 and 2 from interested persons, and simultaneously is approving the proposed rule change, as amended, on an accelerated basis.

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

NASD Regulation proposes to amend NASD Rules 2520 "margin Requirements," and 2522 "Definitions Related to Options, Currency Warrants, Currency Index Warrants, and Stock Index Warrants Transactions" to: (1) Expand the types of short options positions that would be considered "covered" and eligible for the cash account to include short positions that are components of certain limited risk spread strategies (box spreads, butterfly spreads, and debits and credit spreads), provided that any potential risk to the carrying broker-dealer is paid for in full and retained in the account; (2) allow an escrow agreement that conforms to NASD standards to serve in lieu of cash or cash equivalents for certain spread positions held in a cash account; (3) reduce the required margin for butterfly and box spreads by recognizing butterfly and box spreads as strategies (rather than separate transactions) for purposes of margin treatment; (4) recognize various hedging strategies involving stocks (or other underlying instruments) paired with long options, and reduce the required maintenance margin on such hedged stock positions; (5) permit the extension of credit on certain long term options and warrants with over nine months until expiration; (6) permit the extension of credit on certain long box spreads; and (7) provide that the minimum margin requirements for a short put on a listed option will be the current value of the put plus a specified percentage of the put option's aggregate exercise price, and the minimum margin requirement for a short put on an over-the-counter ("OTC") option will be a specified percentage of the put option's aggregate exercise price.

and (6) clarify the purpose of NASD Regulation's proposed definitions of "current market value," "butterfly spread," and "box spread." Amendment No. 2: (1) Deletes an incorrect reference to currency index warrants in Amendment No. 1 and clarifies that a description in Amendment No. 1 refers to NASD Rule 2520(f)(2)(M)(ii)d rather than NASD Rule 2520(f)(2)(L)(ii)d; (2) provides a revised definition of "escrow agreement;" (3) clarifies the definition of American-style options to indicate that American-style options are exercisable at any time up to and including the day of expiration; and (4) adds a comma in the title of NASD Rule 2522 after the word "Options."

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

In its filing with the Commission, NASD Regulation 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. NASD Regulation has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

##### **Purpose**

NASD Regulation proposes to amend NASD Rule 2520 to: (1) Expand the types of short options positions that would be considered "covered" and eligible for the cash account to include short positions that are components of certain limited risk spread strategies (box spreads, butterfly spreads, and debit and credit spreads), provided that any potential risk to the carrying broker-dealer is paid for in full and retained in the account; (2) allow an escrow agreement that conforms to NASD standards to serve in lieu of cash or cash equivalents for certain spread positions held in a cash account; (3) reduce the required margin for butterfly and box spreads by recognizing butterfly and box spreads as strategies (rather than separate transactions) for purposes of margin treatment; (4) recognize various hedging strategies involving stocks (or other underlying instruments) paired with long options, and reduce the required maintenance margin on such hedged stock positions; (5) permit the extension of credit on certain long term options and warrants with over nine months until expiration; (6) permit the extension of credit on certain long box spreads; and (7) provide that the minimum margin requirement for a short uncovered put on a listed option will be the current value of the put plus a specified percentage of the put option's aggregate exercise price, and the minimum margin requirement for a short uncovered put on an OTC option will be a specified percentage of the put option's aggregate exercise price. In addition, NASD Regulation proposes to amend NASD Rule 2522 to include certain new definitions relating to the proposed rule change.

#### **A. Background**

Until several years ago, the margin requirements governing listed options<sup>4</sup> were set forth in Regulation T, "Credit by Brokers and Dealers."<sup>5</sup> However, Federal Reserve Board amendments to Regulation T that became effective on June 1, 1997, modified or deleted certain margin requirements regarding options transactions in favor of rules to be adopted by the self-regulatory organizations ("SROs"), subject to approval by the Commission.<sup>6</sup>

Following the amendments to Regulation T, an informal ad hoc committee (the "431 Committee") was formed to consider changes to the margin rules of the New York Stock Exchange ("NYSE") and the NASD (NYSE Rule 431 and NASD Rule 2520, respectively). The 431 Committee created various subcommittees, including an Options Subcommittee ("Options Subcommittee"), to ensure that the NYSE's and NASD's margin rules were consistent in order to prevent confusion and avoid conferring advantages on members that are required to comply with one rule and not the other. NASD Regulation proposes to amend NASD Rules 2520 and 2522 based on recommendations by the 431 Committee and the Options Subcommittee. The proposed amendments to NASD Rules 2520 and 2522 are substantially identical to amendments made in proposals filed by the Chicago Board Options Exchange, Inc. ("CBOE") and the NYSE, which the Commission approved.<sup>7</sup>

#### **B. Definitions**

Currently, NASD Rule 2520 defines the "current market value" or "current market price" of an option, currency warrant, currency index warrant, or stock index warrant as the total cost or net proceeds of the option contract or warrant on the day it was purchased or sold. NASD Regulation proposes to revise the definition of "current market value" or "current market price" to indicate that the current market value or current market price of an option, currency warrant, currency index

<sup>4</sup> Listed options are issued by The Options Clearing Corporation ("OCC"), a clearing agency registered pursuant to Section 17A of the Act.

<sup>5</sup> 12 CFR 220 *et seq.* The Board of Governors of the Federal Reserve System ("Federal Reserve Board") issued Regulation T pursuant to the Act.

<sup>6</sup> See Board of Governors of the Federal Reserve System Docket No. R-0772 (April 24, 1996), 61 FR 20386 (May 6, 1996).

<sup>7</sup> See Securities Exchange Act Release Nos. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving File No. SR-CBOE-97-67) ("CBOE Approval Order"); and 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving SR-NYSE-99-03) ("NYSE Approval Order").

warrant, or stock index warrant are as defined in Section 220.2 of Regulation T.<sup>8</sup> The revised definition appears in NASD Rule 2522.

NASD Regulation also proposes to define the "butterfly spread"<sup>9</sup> and "box spread"<sup>10</sup> options strategies.<sup>11</sup> The definitions are important elements of NASD Regulation's proposal to recognize and specify the cash and margin account requirements for butterfly and box spreads. 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 treatments.

In addition, NASD Regulation proposes to define the terms "stock index warrant"<sup>12</sup> and "escrow agreement," as used in connection with cash-settled calls, puts, currency warrants, currency index warrants or stock index warrants carried short and as used in connection with non-cash settled put or call options carried short.<sup>13</sup>

<sup>8</sup> See Amendment No. 1, *supra* note 3.

<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> See Amendment No. 1, *supra* note 3.

<sup>12</sup> The proposal defines a "stock index warrant" as a put or call warrant that overlies a broad index stock group or an industry index stock group. See Amendment No. 1, *supra* note 3.

<sup>13</sup> The proposal defines the term "escrow agreement," when used in connection with cash settled calls, puts, currency warrants, currency index warrants or stock index warrants carried short as any agreement issued in a form acceptable to the Association under which a bank holding cash, cash equivalents, one or more qualified equity securities or a combination thereof in the case of a call option or warrant; or cash, cash equivalents or a combination thereof in the case of a put option or warrant is obligated (in the case of an option) to pay the creditor the exercise settlement amount in the event an option is assigned an exercise notice or, (in the case of a warrant) the funds sufficient to purchase a warrant sold short in the event of a buy-

Finally, NASD Regulation proposes to move the definitions of "exercise settlement amount," "aggregate exercise price" and "aggregate current index value" from NASD Rule 2520(f)(2)(C) to NASD Rule 2522(a) for ease of reference so that the definitions relating to transactions in options, currency warrants, currency index warrants and stock index warrants will be located in NASD Rule 2522.<sup>14</sup>

#### C. Extension of Credit on Long Term Options and Warrants

The proposal would allow extensions of credit on certain long listed and OTC<sup>15</sup> options (*i.e.*, put or call options on a stock or stock index) and warrant products (*i.e.*, stock index warrants, but not traditional stock warrants issued by a corporation on its own stock).<sup>16</sup> The proposal provides no loan value for foreign currency options. Only those options or warrants with expirations exceeding nine months ("long term") will be eligible for credit extension.<sup>17</sup> For long term listed options and warrants, the proposed rule change requires initial and maintenance margin of cost less than 75% of the current market value of the option or warrant. Therefore, NASD members would be able to loan up to 25% of the current market value of a long term listed option or warrant. For example, if an investor purchased a 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 the member. Under the current margin rules, the investor

in. See Amendment No. 2, *supra* note 3. The proposal defines the term "escrow agreement" when used in connection with non-cash settled put or call options carried short as any agreement issued in a form acceptable to the Association under which a bank holding the underlying security (in the case of a call option) or required cash or cash equivalents or a combination thereof (in the case of a put option) 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 in the event the call or put is assigned an exercise notice. See Amendment No. 1, *supra* note 3.

<sup>14</sup> See Amendment No. 1, *supra* note 3.

<sup>15</sup> Unlike listed options, OTC options are not issued by the OCC. OTC options and warrants are not listed or traded on a registered national securities exchange or through the automated quotation system of a registered securities association.

<sup>16</sup> Throughout the remainder of this notice and approval order, the term "warrant" means this type of warrant.

<sup>17</sup> For any stock option, stock index option, or stock index warrant that expires in nine months or less, initial margin must be deposited and maintained equal to at least 100% of the purchase price of the option or warrant. See Amendment No. 1, *supra* note 3.

would be required to pay the entire \$100.

The proposal also would permit the extension of credit on certain long term OTC options and warrants. Specifically, an NASD member firm could extend credit on an OTC put or call option on a stock or stock index, and on an OTC stock index warrant. In addition to being more than nine months from expiration, a marginable OTC option or warrant must: (1) be in-the-money and valued at all times for margin purposes at an amount not to exceed the in-the-money amount; (2) be guaranteed by the carrying broker-dealer; and (3) have an American-style<sup>18</sup> exercise provision. The proposal requires initial and maintenance margin of 75% of the long term OTC option's or warrant's in-the-money amount (*i.e.*, its intrinsic value).

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

#### D. Extension of Credit on Long Box Spread in European-Style Options

The proposal also would permit the extension of credit on long box spreads composed entirely of European-style options<sup>19</sup> that are listed or guaranteed by the carrying broker-dealer. A long box spread is a strategy composed of four option positions and is designed to lock-in the ability to buy and sell the underlying component or index for a profit, even after netting the cost of establishing the long box. The two exercise prices embedded in the strategy determine the buy and the sell price.<sup>20</sup>

For long box spreads made up of European-style options, the proposal would require initial and maintenance

<sup>18</sup> An American-style option is exercisable on any business day prior to its expiration date and on its expiration date. See Amendment No. 2, *supra* note 3.

<sup>19</sup> A European-style option may be exercised only at its expiration pursuant to the rules of the OCC. See NASD Rule 2860(U).

<sup>20</sup> 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 NASD Regulation's proposed definition of "long box spread," 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). See CBOE Approval Order, *supra* note 7, at footnote 22.

margin of 50% of the aggregate difference in the two exercise prices (buy and sell), which results in a margin requirement slightly higher than 50% of the debit typically incurred in establishing such a position.<sup>21</sup> Under the proposal, a long box spread position would be allowed market value for margin equity purposes of not more than 100% of the aggregate difference in the exercise prices of the options.

#### E. Cash Account Treatment of Butterfly Spreads, Box Spreads, and Other Spreads

The proposal would make butterfly and box spreads in cash-settled, European-style options eligible for the cash amount. 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 proposal's definitions of those terms,<sup>22</sup> 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. According to NASD Regulation, full payment of the net debit incurred to establish a long butterfly or box spread will cover any potential risk to the carrying broker-dealer.<sup>23</sup>

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 will require that an amount equal to the maximum risk be held or deposited in the account in the form of cash or cash

equivalents.<sup>24</sup> The maximum potential risk in a short butterfly spread comprised of all options is the aggregate difference between the two lowest exercise prices.<sup>25</sup> With respect to short butterfly spreads comprised of put options, the maximum potential risk 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.

NASD Regulation'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.<sup>29</sup> 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 margin account, where all option positions making up the box spread are listed or guaranteed by the carrying broker-dealer, also are the same

<sup>24</sup> 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.

<sup>25</sup> 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 proposed rule change, 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 = 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). See CBOE Approval Order, *supra* note 7, at footnote 27.

<sup>29</sup> See *supra*, Section II.E., "Cash Account Treatment of Butterfly Spreads, Box Spreads, and Other Spreads." The margin requirements would apply to butterfly spreads where all option positions are listed or guaranteed by the carrying broker-dealer.

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 it incurred when the spread strategy is established.<sup>30</sup> 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; 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. Margin Requirements for Short Put Options

NASD Rule 2520(f)(2)(D)(i) currently provides that the minimum required margin for a short listed put option is an amount equal to the option premium plus a percentage of the current value of the underlying instrument. The minimum required margin for a short OTC put option is an amount equal to a percentage of the current value of the underlying component. According to NASD Regulation, the NASD's current rule creates a margin requirement for a short put option even when the price of the underlying instrument rises above the exercise price of the put and the risk associated with the put option has decreased because the option is out-of-the-money. NASD Regulation proposes to amend the margin requirement for short put options to provide a minimum margin requirement more in line with the risk associated with the option. Specifically, NASD Regulation proposes to amend NASD Rule 2520(f)(2)(D) to provide the minimum margin requirement for a short listed put option will be an amount equal to the current value of the option plus a percentage of the option's aggregate exercise price. The minimum margin required for a short OTC put option would be an amount equal to a specified percentage of the options' aggregate exercise price.

Short box spreads also generate a credit balance when established. This credit is nearly equal to the total debit

<sup>30</sup> 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.

<sup>21</sup> Using the example in the preceding footnote, the margin required (50% × (60 - 50) = 5) would be slightly higher than 50% of the net debit (50% × 9½ = 4¾). See CBOE Approval Order, *supra* note 7, at footnote 23.

<sup>22</sup> See notes 9 and 10, *supra*.

<sup>23</sup> For example, to create a long butterfly spread comprised of all 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 next debit incurred to establish the strategy ((3 + 3) - (6 + 1) = net debit of 1). Under the proposed rule change, the investor would be required to pay the net debit, or \$100 (1 × 100). See CBOE Approval Order, *supra* note 7, at footnote 25.

(loss) that, in the case of a short box spread, will accrue to the account if held to expiration. The proposed rule change will 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.<sup>26</sup> 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.<sup>27</sup>

In addition to butterfly spreads and box spreads, the proposal will permit investors to hold in their cash accounts other spreads made up of European-style, cash-settled stock index options or stock 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 or stock index warrant was held in, or purchased for, the account on the same day.<sup>28</sup> 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.

<sup>26</sup> 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 such amount in the event the account is assigned an exercise notice on either short option.

<sup>27</sup> For example, 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 NASD Regulation's proposed definition of "short box spread (*supra* note 10)," 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). See CBOE Approval Order, *supra* note 7, at footnote 29.

<sup>28</sup> 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. If the long position is not listed, it must be guaranteed by the carrying broker-dealer; otherwise the short position is not eligible for the cash account and must be margined separately pursuant to NASD Rule 2520(f)(2)(D). See Amendment No. 1, *supra* note 3.

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

The NASD's margin rules presently do not recognize butterfly spreads for margin purposes. Under NASD's current margin rules, the two spreads (bullish and bearish) that make up a butterfly spread each must be margined separately. NASD Regulation 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.

#### H. Maintenance Margin Requirements for Stock Positions Held With Options Positions

NASD Regulation 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.<sup>31</sup> 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 stock positions held in conjunction with an overlying option (or options), the proposal is structured to apply also to components that underlie index options and warrants. For example, these same maintenance margin requirements will apply when these strategies are used with a stock basket underlying index options or warrants. Proposed NASD Rule 2520(f)(2)(G)(v) will define the five strategies and set forth the respective maintenance margin requirements for the stock component of each strategy.<sup>32</sup>

##### 1. Long Put/Long Stock

The Long Put/Long Stock hedging 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. This strategy is designed to

<sup>31</sup> Generally, NASD Rule 2520(c) requires maintenance margin of 25% for all securities "long" in an account. 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.

<sup>32</sup> NASD Regulation's proposal provides maintenance margin relief for the stock component (or other underlying instrument) of the five identified strategies. 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 NASD does not possess independent authority to lower the initial margin requirement for the stock.

limit downside risk in the underlying stock while the put is held. The put holder retains the right to sell stock at the strike price through the expiration of the put. The maintenance margin requirement for the Long Put/Long Stock combination would be the lesser of: (a) 10% of the put option aggregate exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (b) 25% of the current market value of the long stock position.<sup>33</sup>

##### 2. Long Call/Short Stock

The Long Call/Short Stock hedging 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 the equivalent units of the underlying component. This strategy is designed to limit the risk associated with upside appreciation in the underlying stock during the life of the call. The call holder retains the right to buy the stock at the strike price through the expiration of the call. For a Long Call/Short Stock combination, the maintenance margin requirement would be the lesser of: (a) 10% of the call option aggregate exercise price, plus 100% of any amount by which the call option is out-of-the-money; or (b) the maintenance margin requirement on the short stock position as specified in NASD Rule 2520(c).<sup>34</sup>

##### 3. Conversion (Long Stock/Long Put/Short Call)

A "Conversion" is a long stock position in conjunction with a long put and a short call. For a Conversion to qualify as hedged, the long put and the short call must have the same expiration 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

<sup>33</sup> For example, if an investor is long 100 shares of XYZ @ 52 and long one XYZ Jan 50 Put @ 2, the required 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). See CBOE Approval Order, *supra* note 7, at footnote 34.

<sup>34</sup> As discussed in note 29, *supra*, NASD Rule 2520(c) provides a maintenance margin requirement of the greater of \$2.50 per share or 100% of the current market value for each stock carried short that has a current market value of less than \$5 per share. 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. Thus, for an investor who is short 100 shares of XYZ @ 48 and long 1 XYZ Jan 50 Call @ 1, the proposed margin would be the lesser of ((10% × 50) + (100% × 2) = 7) or (30% × 48 = 14.4). Therefore, the investor would be required to maintain margin equal to at least \$700 (7 × 100). See CBOE Approval Order, *supra* note 7, at footnote 35.

of the long put. Thus, regardless of any decline in market value, the stock position, in effect, is worth no less than the exercise price of the put.

Current NASD margin rules 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 current maintenance margin requirement (*i.e.*, 25% of the current market value).<sup>35</sup> Under the proposed rule change, the maintenance margin requirement for a Conversion would be 10% of the aggregate exercise price.<sup>36</sup>

#### 4. Reverse Conversion (Short Stock/Short Put/Long Call)

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. 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. Under the proposed rule change, the maintenance margin requirement for a Reverse Conversion would be 10% of the aggregate 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).<sup>37</sup>

<sup>35</sup> For example, for an investor who is long 100 shares of XYZ @ 48, long one XYZ Jan 50 Put @ 2, and short one XYZ Jan 50 Call @ 1, the current maintenance margin on the long stock position would be \$1,200 ((25%×48)×100). However, if the price of the stock increased to 60, NASD rules currently specify 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. See CBOE Approval Order, *supra* note 7, at footnote 36.

<sup>36</sup> 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). See CBOE Approval Order, *supra* note 7, at footnote 37.

<sup>37</sup> 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 one XYZ Jan 50 Call @ 2 1/2, and short one XYZ Jan 50 Put @ 1 1/2. If the current market value of XYZ stock drops to 30, the maintenance margin would be \$2,500 ((10% × 50

#### 5. Collar (Long Stock/Long Put/Short Call)

A "Collar" is a long stock position held in conjunction with a long put and a short call. In a Collar, as compared to a Conversion, 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 under the proposed rule change would be the lesser of: (a) 10% of the long put aggregate exercise price, plus 100% of any amount by which the long put is out-of-the-money; or (b) 25% of the short call aggregate exercise price.<sup>38</sup> Current NASD margin requirements specify that the stock may not be valued at more than the call exercise price.

#### I. Determination of Value for Margin Purposes

The proposal would revise NASD Rule 2520(f) to allow 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 nine months from expiration).<sup>39</sup> Currently, NASD Rule 2520(f) does not allow certain long term options or warrants to have market value for margin equity purposes. The revision would allow options and warrants eligible for loan value under proposed NASD Rule 2520(f) to have market value 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.

#### Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>40</sup> which requires, among other things, that the rules of the Association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change will promote the safety and soundness of member firms and is

+ (50 - 30) × 100. See CBOE Approval Order, *supra* note 7, at footnote 38.

<sup>38</sup> 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 ((100% × 45) + 3 = 7 1/2) or (25% × 50 = 12 1/2). Therefore, the investor would need to maintain at least \$750 (7 1/2 × 100) in margin. See CBOE Approval Order, *supra* note 7, at footnote 39.

<sup>39</sup> See Amendment No. 1, *supra* note 3.

<sup>40</sup> 15 U.S.C. 78o-3(b)(6).

consistent with the rules and regulations of the Federal Reserve Board because it is designed to prevent the excessive use of credit for the purpose or carrying of securities, pursuant to Section 7(a) of the Act.

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

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments were neither solicited nor received.

### III. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change and Amendment Nos. 1 and 2

For the reasons discussed below, the commission finds the proposed rule change, as amended, is consistent with the Act and the rules and regulations under the Act applicable to a national securities association. In particular, the commission finds that the proposed rule change, as amended, is consistent with the Section 15A(b)(6)<sup>41</sup> requirements that the rules of a national securities association be designed to promote just and 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 NASD Regulation's margin requirements to better reflect the risk of certain hedged options strategies.<sup>42</sup>

Specifically, the Commission believes that it is appropriate for NASD Regulation 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 SROs to adopt rules permitting the margining of options.<sup>43</sup> As noted above, the NASD rules approved in this order, which will permit the margining of options under the grant of authority from the Federal Reserve Board, are

<sup>41</sup> 15 U.S.C. 78o-3(b)(6).

<sup>42</sup> In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78f(c)(f).

<sup>43</sup> See note 6, *supra*.

substantially identical to rules adopted recently by the NYSE and the CBOE.<sup>44</sup>

The Commission believes that it is reasonable for NASD Regulation 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 collateral (*i.e.*, the long term option or warrant) that has sufficient value.<sup>45</sup> Because the expiration dates attached to options and warrants make such securities wasting assets by nature, it is important that NASD Regulation 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.<sup>46</sup>

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 long term OTC option's or warrant's current market value. 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).<sup>47</sup> The Commission notes 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 NASD 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 NASD'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 NASD 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.<sup>48</sup> Moreover, some creditors, such as OCC, extend credit on options as part of their current business.<sup>49</sup> The Commission believes that because option 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.<sup>50</sup> The Commission understands that the current bar

preventing broker-dealers from extending credit on options may place some NASD member firms at a competitive disadvantage relative to other financial service firms. By permitting NASD members to extend credit on long term options and warrants, the proposal should enable NASD members to better serve customers and offer additional financing alternatives.

The Commission believes that it is appropriate for NASD Regulation 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 NASD 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 aggregate 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 NASD'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.<sup>51</sup> 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

<sup>48</sup> 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).

<sup>49</sup> In this regard, the Commission notes that the CBOE, in its options margin proposal, stated that "[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 CBOE Approval Order, *supra* note 7.

<sup>50</sup> See Board of Governors of the Federal Reserve System Docket Nos. R-0905, R-0923, and R-0944 (January 8, 1998), 63 FR 2806 (January 16, 1998). In adopting the final rules that permitted non-broker-dealer lenders to extend credit on listed options, the Federal Reserve Board stated 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 Federal Reserve 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").

<sup>51</sup> However, for long box spreads made up of European-style options, the margin requirement is 50% of the aggregate difference in the two exercise prices.

<sup>44</sup> See CBOE Approval Order and NYSE Approval Order, *supra* note 7.

<sup>45</sup> The value of an option contract is made up of two components: intrinsic value and time value. Intrinsic value, or the in-the-money-amount, 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.

<sup>46</sup> For similar reasons, the Commission believes that it is appropriate for the NASD to permit the extension of credit on long box spreads 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.

<sup>47</sup> See Amendment No. 1, *supra* note 3.

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 options positions serve to offset each other with respect to risk. 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 stock index options and stock 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 stock index option or stock 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 appropriate for NASD Regulation 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 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 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: (1) 10% of the put option aggregate exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (2) 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.<sup>52</sup>

The Commission notes that the proposed changes were reviewed carefully by the 431 Committee and the Options Subcommittee, which are comprised of industry participants who have extensive experience in margin and credit matters. In addition, as noted above, NASD Regulation's proposal is substantially identical to rules adopted by the CBOE and the NYSE, which the Commission approved.<sup>53</sup> In approving the CBOE's proposal, the Commission noted the CBOE's experience in monitoring the credit exposures of options strategies and the fact that the CBOE regularly examines the coverage of options margin as it relates to price movements in the underlying securities and index components.<sup>54</sup> 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 NASD member may freely implement margin requirements that exceed the margin requirements by adopted by NASD Regulation.<sup>55</sup> The Commission recognizes that the NASD's margin requirements serve as non-binding benchmarks, and that NASD members often establish different margin requirements for their customers based on a number of factors, including market volatility. The Commission encourages NASD members to continue to perform independent and rigorous analysis when determining prudent levels of margin for customers.

The Commission believes that it is appropriate for the NASD to revise Rule 2520(f) (1) and (2) to allow the market value of certain long term stock options, stock index options, and stock index warrants to have market value for margin equity purposes. Under the

<sup>52</sup> For example, for an investor who is long 100 shares of XYZ @ 52 and long 1 XYZ Jan 50 Put @ 2, the margin required under the proposal would be \$700—the lesser of  $((10\% \times 50) + (100\% \times 2) = 7)$  or  $(25\% \times 52 = 13)$ . In contrast, the current margin requirement would be \$1,300 a difference of \$600. See CBOE Approval Order, *supra* note 7, at footnote 63.

<sup>53</sup> See CBOE Approval Order and NYSE Approval Order, *supra* note 7.

<sup>54</sup> See CBOE Approval Order, *supra* note 7.

<sup>55</sup> In this regard, the Commission notes that NASD Rule 2520(d). "Additional Margin," requires NASD members to: (1) review limits and types of credit extended to all customers; (2) formulate their own margin requirement; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by NASD Rule 2520 for individual securities or customer accounts.

current terms of NASD Rule 2520(f) (1) and (2), options contracts are not deemed to have market value. Because NASD Regulation's proposal will allow extensions of credit on certain long term options and warrants, NASD Rule 2520(f) (1) and (2) must be revised to permit such marginable options and warrants to have market value for margin purposes. The Commission notes that unless NASD Rule 2520(f) (1) and (2) are revised to recognize the market value of the marginable options and warrants, the NASD'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 also believes that it is reasonable for the NASD Regulation to define "butterfly spread" and "box spread." These definitions will specify which multiple options positions, if held together, qualify for classification as butterfly or box spreads, and consequently are eligible for the proposed cash and margin treatments. The Commission believes that it is important for the NASD to clearly define which options strategies are eligible for the proposed margin treatment.

Moreover, the Commission believes that it is reasonable for NASD Regulation to define the term "escrow agreement," when used in connection with non cash-settled call or put options carried short, and when used in connection with cash-settled call or put options carried short, to establish clear requirements for both of these types of escrow agreements. The Commission believes that the proposed definitions will help to clarify the requirements for these types of escrow agreements.

The Commission also finds that the NASD's definition of the term "stock index warrant" is reasonable because it conforms an NASD rule to an existing NYSE rule.<sup>56</sup>

The Commission also believes that it is reasonable for NASD Regulation to revise its definition of "current market value" and "current market price" to provide that the terms "current market value" and "current market price" of an option, currency warrant, currency index warrant or stock index warrant are as defined in Section 220.2 of Regulation T. A linkage to the Regulation T definition should keep the NASD's definition equivalent to Regulation T without requiring a rule filing if the Federal Reserve Board revises its definition of Regulation T. In

<sup>56</sup> See NYSE Rule 414(a).

addition, the Commission believes that it is reasonable for NASD Regulation to move its definitions of "current market value," "current market price," "exercise settlement amount," "aggregate exercise price," and "aggregate current index value" from NASD Rule 2520 to NASD Rule 2522 for ease of reference purposes so that all the definitions relating to transactions in options, currency warrants, currency index warrants and stock index warrants will be located under NASD Rule 2522. The Commission believes that NASD members and other market participants will find the consolidated margin definitions easier to locate and use.

Further, the Commission believes that it is reasonable for NASD Regulation to modify NASD Rule 2450(f)(2)(D) to provide that the minimum customer margin requirement for a short put on a listed equity will be the current value of the put plus 10% of the put's aggregate exercise price; and that the minimum customer margin requirement for a short put on an OTC equity will be 10% of the put's aggregate exercise price. The proposed change will make NASD Regulation's treatment of short equity put options consistent with the CBOE and NYSE treatment of short equity put options.<sup>57</sup>

The revisions to NASD margin rules will significantly impact the way NASD members calculate margin for options customers. The Commission believes that it is important for NASD Regulation 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 February 26, 2001 or such date NASD Regulation represents in writing to the Commission that NASD Regulation is prepared to fully implement and monitor the approved margin requirements.

The Commission expects NASD Regulations to issue a notice 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 NASD Regulation 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 the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register** because the proposal is substantially identical to proposals filed by the CBOE and NYSE, which the Commission approved previously.<sup>58</sup> The Commission also 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 strengthens NASD Regulation's proposal by, among other things, clarifying the requirements for stock index option and stock index warrant spreads carried in a cash account. Specifically, NASD Rule 2520(f)(2)(M)(ii)d, as amended, provides that if the long stock index option or warrant position is not listed, it must be guaranteed by the carrying broker-dealer or the offsetting short position would not be eligible for the cash account and would be margined separately pursuant to NASD Rule 2520(f)(2)(D). Because this change conforms the NASD's rule to the CBOE and NYSE rules that were approved by the Commission,<sup>59</sup> the change raises no new material regulatory issues. In addition, Amendment No. 1 makes technical corrections, clarifies the purpose of proposed definitions, and indicates that the minimum amount of margin that must be maintained in various hedged strategies is the aggregate exercise price (rather than the exercise price). Amendment No. 2 strengthens the NASD's proposal by making technical corrections and by clarifying the definitions of "American-style option," and "escrow agreement," as used in connection with cash settled instruments.

Based on the above, the Commission finds that good cause exists, consistent with Section 19(b) of the Act,<sup>60</sup> to accelerate approval of the proposal and Amendment Nos. 1 and 2 to the proposal.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change and Amendment Nos. 1 and 2 are 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 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 such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-00-15 and should be submitted by December 19, 2000.

#### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>61</sup> that the proposed rule change (SR-NASD-00-15), as amended, is approved. The approved margin requirements shall become effective the earlier of February 26, 2001 or such date the Association represents in writing to the Commission that the Association is prepared to fully implement and monitor the approved margin requirements.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>62</sup>

**Jonathan G. Katz,**  
Secretary.

[FR Doc. 00-30196 Filed 11-27-00; 8:45 am]

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43597; File No. SR-NSCC-00-11]

#### Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Automated Customer Account Transfer Services Procedures

November 20, 2000.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on August 28, 2000, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") and on September 25, 2000, amended the proposed rule change as described in

<sup>58</sup> See CBOE Approval Order and NYSE Approval Order, *supra* note 7.

<sup>59</sup> *Id.*

<sup>60</sup> 15 U.S.C. 78s(b).

<sup>61</sup> 15 U.S.C. 78s(b)(2).

<sup>62</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>57</sup> See CBOE Rule 12.3(c)(5) and NYSE Rule 431(f)(2).