and during other, non-emergency situations for certain option classes. The Exchange believes that automatic executions of orders for up to 250 contracts will allow for the quick, efficient execution of public customer orders.

III. Discussion

After careful review, 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 exchange and, in particular, the requirements of Section 6 of the Act.[6] Among other provisions, Section 6(b)(5) of the Act requires that the rules of an exchange be designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating securities transactions; remove impediments to and perfect the mechanism of a free and open market and a national market system; and protect investors and the public interest.[7]

While increasing the maximum order size limit from 100 contracts to 250 contracts for automatic execution eligibility by itself does not raise concerns under the Act, the Commission believes that this increase raises collateral issues that the Amex will need to monitor and address. Increasing the maximum order size for particular option classes will make a larger number of option orders eligible for AUTO–EX. These orders may benefit from greater speed of execution, but at the same time create greater risks for market maker participants. Market makers signed on to the Amex's AUTO–EX system will be exposed to the financial risks associated with larger-sized orders being routed through the system for automatic execution at the displayed price. When the market for the underlying security changes rapidly, it may take a few moments for the related option's price to reflect that change. In the interim, customers may submit orders that try to capture the price differential between the underlying security and the option. The larger the orders accepted through AUTO–EX, the greater the risk market makers must be willing to accept. The Commission does not believe that, because Amex floor governors or senior floor officials determine to approve orders as large as 250 contracts as eligible for AUTO–EX, Amex floor governors or senior floor officials or Amex staff should disengage AUTO–EX more frequently by, for example, declaring an ''unusual market condition.'' [8] Disengaging AUTO–EX can negatively affect investors by making it slower and less efficient to execute their orders. It is the Commission's view that the Amex, when increasing the maximum size of orders that can be sent through AUTO–EX, should not disadvantage all customers—the vast majority of whom enter orders for less than 250 contracts—by making their automatic execution systems less reliable.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5).[9]

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[10] that the proposed rule change (SR–Amex–2001–94) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[11]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–7611 Filed 3–28–02; 8:45 am]

BILLING CODE 8010–01–P

[6] The Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

[7] 15 U.S.C. 78f(b)(5).

[8] The Amex has filed a proposed rule change (File No. SR–Amex–2001–74) with the Commission that would codify the Exchange's current practices and policies by specifying (i) the circumstances under which AUTO–EX can be disengaged or operated in a manner other than the normal manner set forth in Exchange rules and policies and (ii) the required documentation of the reasons for any action to disengage AUTO–EX to operate in a manner other than normal. The proposed rule change was filed pursuant to the Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act Release No. 43268 (September 11, 2000) (File No. 3–10282) and is pending with the Commission.

[9] 15 U.S.C. 78f(b)(5).

[10] 15 U.S.C. 78s(b)(2).

[11] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45630; File No. SR–CBOE–2002–03]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Incorporated Relating to Customer Portfolio and Cross-Margining Requirements

March 22, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 15, 2002, the Chicago Board Options Exchange, Inc. (''CBOE'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The CBOE proposes to amend its rules, for certain customer accounts, to allow member organizations to margin listed, broad-based, market index options, index warrants and related exchange-traded funds according to a portfolio margin methodology as an alternative to the current strategy-based margin methodology. The proposed rule change will also provide for cross-margining by allowing broad-based index futures and options on such futures to be included with listed, broad-based index options, index warrants and related exchange-traded funds for portfolio margin treatment.

The text of the proposed rule change is available at the Office of the Secretary, CBOE, at the Commission, and on the Commission's website.

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

In its filing with the Commission, the CBOE 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. The CBOE has prepared summaries, set forth in

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

[2] 17 CFR 240.19b–4.

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

1. Purpose

a. Introduction

The CBOE proposes to expand its margin rules by providing a portfolio margin methodology for listed, broad-based market index options, index warrants and related exchange-traded funds that clearing member organizations may extend to eligible customers as an alternative to the current strategy-based option margin requirements. The proposed rule change would also allow broad-based index futures and options on such futures to be included in a portfolio margin account, thus providing a cross-margin capability. The CBOE seeks to introduce the proposed new rule as a two-year pilot program that would be made available to member organizations on a voluntary basis.

The proposed rule change would permit self-clearing member organizations to apply a prescribed portfolio margin methodology to an account[3] of an affiliate, another broker-dealer, and an account of a member of a national futures exchange who is a futures floor trader. Any other customers of the clearing member would be required to have account equity of at least $5 million to be eligible for portfolio margin treatment. This circumscribes the number of accounts able to participate and adds safety in that such accounts are more likely to be of significant financial means and investment sophistication. Further, portfolio margining is most effective when applied to larger accounts with diverse option positions and related securities, and any related futures contracts. It is expected that institutional customers will be the primary participants. Whether the account equity requirement should be lowered to allow participation of more customers will be assessed at the end of the pilot program period. Application of portfolio margin, including cross-margin, to an IRA account would be prohibited under the proposed rule change.

The proposed portfolio margin and cross-margin rules have been developed by the CBOE in cooperation with The Options Clearing Corporation (''The OCC''), the New York Stock Exchange, Inc. (''NYSE''), the American Stock Exchange, LLC (''AMEX''), the Board of Trade of the City of Chicago, Inc. (''CBOT''), and the Chicago Mercantile Exchange, Inc. (''CME''). The CBOE intends to provide a written overview describing the operational details of the portfolio margin and cross-margin pilot program to potential member organization participants to introduce and explain the pilot program.

A committee of representatives from the member organizations identified as potential participants, and staff of the sponsoring exchanges and The OCC (the ''Portfolio Margin Committee'') was formed and met several times in 1999 and 2000 to refine the portfolio margin and cross-margin pilot program. This group has recommended adoption of the portfolio margin and cross-margin pilot program, as finalized by the group, and the related rule proposals. In addition, the portfolio margin and cross-margin pilot program has been presented to the NYSE's Rule 431 Committee[4] on two occasions, with draft rules included on the second occasion, and has received the NYSE's Rule 431 Committee's support.

b. Overview—Portfolio Margin Computation

(1) Portfolio Margin

Under a portfolio margin system, margin is required based on the greatest loss that would be incurred in a portfolio if the value of components (underlying instruments in the case of options) move up or down by a predetermined amount (*e.g.,* +/−5%). Under the Exchange's proposed portfolio margin rule, listed index options and underlying instruments (also related instruments[5] in the case of a cross-margin account) would be grouped by class[6] (*e.g.,* S&P 500, S&P 100, etc), each class group being a portfolio.[7] The gain or loss on each position in a portfolio would be calculated at each of 10 equidistant points (''valuation points'') set at and between the upper and lower market range points. A theoretical options pricing model would be used to derive position values[8] at each valuation point for the purpose of determining the gain or loss. Gains and losses would then be netted for positions within the class or portfolio at each valuation point. The greatest net loss among the 10 valuation points would be the margin required on the portfolio or class. The margin for all other portfolios within an account would be calculated in a similar manner. Broad-based index classes (portfolios) that are highly correlated would be allowed offsets such that, at the same valuation point, for example, 90% of a gain in one class may reduce or offset a loss in another class. The amount of offset allowed between portfolios would be the same amount that is permitted under the risk-based haircut methodology set forth in Appendix A of the Commission's net capital rule.[9] A per contract minimum would be established and would override if a lesser requirement is rendered by the portfolio margin computation.[10]

Member organizations would not be permitted to use any theoretical pricing model to generate the prices used to calculate theoretical profits and losses. Under the proposed rule change, the theoretical prices used for computing profits and losses must come from a theoretical pricing model that, pursuant to the Commission's net capital rule,[11] qualifies for purposes of determining the amount to be deducted in computing net capital under a portfolio-based methodology. CBOE believes that delineating acceptable theoretical pricing models is best achieved by applying the Commission's net capital rule by reference. In this way, consistency with the Commission's net capital rule is maintained. In addition, since theoretical pricing models must be approved by a Designated Examining Authority (''DEA'') and reviewed by the Commission to qualify, uniformity across models can be assured. As a result, portfolio margin and cross-margin requirements will not vary materially from firm to firm. Currently, the theoretical model used by The OCC is the only model qualified pursuant to the Commission's net capital rule.

3 An account dedicated to portfolio margining.

4 The NYSE Rule 431 Committee is comprised of securities industry representatives, primarily representatives of NYSE member organizations. NYSE Rule 431 contains the NYSE's margin rules. The function of the NYSE Rule 431 Committee is to assess the adequacy of NYSE Rule 431 on an ongoing basis, review proposals for changes to NYSE Rule 431, and recommend changes that are deemed appropriate.

5 Under the proposed rule change, the term ''related instrument'' would mean, with respect to an options class or product group, futures contracts and options on futures contracts covering the same underlying instrument.

6 Under the proposed rule change, the term ''options class'' would refer to all options contracts covering the same underlying instrument.

7 CBOE's pilot program would permit an exchange-traded fund structured to replicate the composition of the index to be included; however, stock baskets would not be permitted at this time.

8 Position values would represent the difference between the position closing price and the theoretical value at each valuation point.

9 Rule 15c3–1a under the Act, 17 CFR 240.15c3–1a.

10 The proposed rules set a per contract minimum of $37.50.

11 *See* Rule 15c3–1a(b)(1)(i)(B) under the Act, 17 CFR 240.15c3–1a(b)(1)(i)(B).

Consequently, all member organizations participating in the pilot program would, at least for the foreseeable future, obtain their theoretical values from The OCC.

The Exchange's proposed rule would propose a market range of +/−10% for computing theoretical gains and losses in broad-based, non-high capitalization index portfolios. A market range of +6%/−8% is proposed for broad-based, high capitalization index portfolios.[12] These are the same ranges currently applied to options market makers for the purpose of computing portfolio or risk-based haircuts. On a historical basis, these ranges cover one day moves at a very high level of confidence, and would be competitive with the market range coverage applied for performance bond (margin) purposes in the futures industry on comparable index futures. The proposed rule change requires that a separate securities margin account (or subaccount of a securities margin account) be used for portfolio margining.

(2) Cross-Margining

Related index futures and options on such futures would be allowed to be carried in the portfolio margin account, thus affording a cross-margin capability. Alternatively, the proposed rule change permits a clearing member to establish a separate portfolio margin account (securities margin account) exclusively for cross-margining. In a portfolio margin account, including one that is used exclusively for cross-margining, constituent portfolios may be formed containing index options, index warrants and exchange-traded funds structured to replicate the composition of the index underlying a particular portfolio, as well as related index futures and options on such futures. Cross-margining would operate similar to the cross-margin program that was approved by the Commission and the Commodity Futures Trading Commission (''CFTC'') for listed options market-makers and proprietary accounts of clearing member organizations. There is one major difference in that a securities account would be used instead of a futures account and, therefore, SEC customer protection rules and insurance coverage by the Securities Investor Protection Corporation (''SIPC'') would apply instead of CFTC rules concerning customer protection and liquidation proceedings. For determining theoretical gains and losses, and resultant margin requirements, the same portfolio margin computation program will be applied to portfolio margin accounts that contain a cross-margin element, to portfolio margin accounts that do not contain a cross-margin element, and to portfolio margin accounts used exclusively for cross-margining.

c. Margin or Minimum Equity Deficiency

Under proposed CBOE Rule 12.4(h), positions in a portfolio margin account would be valued at current market prices, as currently defined in the Exchange's margin rules. Under the proposed rule change, account equity would be calculated and maintained separately for each portfolio margin account. For purposes of the $5 million minimum account equity requirement, all accounts owned by an individual or entity may be combined. Proposed CBOE Rule 12.4(i) requires that additional margin must be obtained with one business day (T+1) whenever equity is below the margin required, regardless of whether the deficiency is caused by the addition of new positions, the effect of unfavorable market movement on existing positions, or a combination of both. The portfolio margin requirement, therefore, would be both the initial and maintenance margin requirement, and no differentiation would be necessary. In addition, proposed CBOE Rule 12.4(g) would require that, in the event account equity falls below the $5 million minimum, additional equity must be deposited within 3 business days (T+3). If the deficiency were not resolved within 3 business days, the carrying member organization would be prohibited under the proposed rule change from accepting any new opening orders beginning on T+4, with the exception of opening orders that hedge existing positions. This prohibition would remain in effect until a $5 million equity was established.

d. Risk Disclosure Statement and Acknowledgement

In addition, the Exchange proposes that member organizations provide every portfolio margin customer with a written risk disclosure statement at or prior to the initial opening of a portfolio margin account.[13] This disclosure statement highlights the risks and operation of portfolio margin accounts, including cross-margining, and the differences between portfolio margin and strategy-based margin requirements. The disclosure statement is divided into two sections, one dealing with portfolio margining and the other with cross-margining. The disclosure statement clearly notes that additional leverage is possible in an account margined on a portfolio basis in relation to strategy-based margin. Among other things, the disclosure statement covers who is eligible to open a portfolio margin account, the instruments that are allowed, and when deposits to meet margin and minimum equity are due. The fact that long option positions held in a portfolio margin account are not segregated, as they generally would be in the case of a regular margin account under the Commission's customer protection rules, is explained. Also included within the portfolio margin section is a summary list of the special risks of portfolio margin accounts, such as: increased leverage; shorter time for meeting margin; involuntary liquidation if margin not received; inability to calculate future margin requirements because of the data and calculations required; and that long positions are subject to a lien. The risks and operation of a cross-margin feature are outlined in the cross-margin section of the disclosure statement, and a summary list of the special risks associated with cross-margining is included.

Further, at or prior to the time a portfolio margin account is initially opened, member organizations would be required to obtain a signed acknowledgement concerning portfolio margining in general from the customer. In addition, prior to accommodating cross-margining, member organizations would be required to obtain a second signed acknowledgement within the same time frame that pertains to cross-margin.

By signing the general acknowledgement required of all customers, the customer would attest to having read the disclosure statement and being aware of the fact that long option positions in a portfolio margin account (which includes cross-margin accounts) are not subject to the segregation requirements under the customer protection rules of the Commission, and would be subject to a lien by The OCC. In signing the

[12] CBOE believes that it is imperative that these market move ranges be competitive with the range used in the futures industry for computing margin (performance bond) on broad-based index futures. The proposed ranges accomplish this goal. Customer performance bond in the futures industry is computed using a portfolio margining system known as the Standard Portfolio Analysis of Risk (''SPAN''). The terms ''high capitalization'' and ''non-high capitalization'' have the same meaning as they do for the purposes of risk-based haircuts (Rule 15c3–1 under the Act, 17 CFR 240.15c3–1).

[13] Even a customer that engages exclusively in cross-margining is a portfolio margin customer, as the proposed rule change permits cross-margining to be conducted only by applying the portfolio margin methodology.

additional acknowledgement applicable to cross-margining, the customer would attest to having read the disclosure statement and being aware of the fact that futures positions are being carried in a securities account, are subject to the Commission's customer protection rules,[14] and fall under the authority of the SIPC in the event the carrying broker-dealer becomes financially insolvent. Within Chapter 9 of the Exchange's rules (''Doing Business with the Public''), the Exchange would prescribe the format of the written disclosure statement and acknowledgements in proposed Exchange Rule 9.15(d)—Delivery of Current Options Disclosure Documents and Prospectus. Like a current Exchange rule that prescribes the format for a Special Statement for Uncovered Options Writers (CBOE Rule 9.15(c)), proposed Exchange Rule 9.15(d) would allow member organizations to develop their own format, provided it contains substantially similar information and it is approved in advance by the Exchange.

e. Net Capital

The Exchange also proposes to add a new requirement in CBOE Rule 13.5 to mandate that the gross customer portfolio margin requirements of a broker-dealer may at no time exceed 1,000 percent of a carrying broker-dealer's net capital (a 10:1 ratio). This requirement is intended to place a ceiling on the amount of margin a broker-dealer can extend to its customers in relation to its net capital.

f. Internal Risk Monitoring Procedures

The Exchange further proposes a separate, related rule that would require member organizations that carry portfolio margin or cross-margin accounts to establish and maintain written procedures for assessing and monitoring the potential risks to their capital. Specifically, proposed CBOE Rule 15.8A (Risk Analysis of Portfolio Margin and Cross-Margin Accounts) would require that the member organization file and maintain its current procedures with its DEA, and provide the DEA with such information as the DEA may reasonably require regarding the member organization's risk analysis of any and all portfolio margin and cross-margin accounts carried for customers. Proposed CBOE Rule 15.8A would incorporate current Exchange Rule 15.8—Risk Analysis of Market-Maker Accounts—by reference to require that the risk analysis be conducted in the same manner as prescribed in Exchange Rule 15.8. Additionally, proposed CBOE Rule 15.8A would set forth certain undertakings that must be included in the written procedures (*e.g.*, review and approval of credit limits for each customer and across all accounts).

Because member organizations would be required under the proposed rule change to have risk monitoring procedures, proposed CBOE Rule 12.4(i) states that the current CBOE Rule 12.9—Meeting Margin Calls by Liquidation Prohibited—prohibiting excessive liquidations to meet margin requirements will not apply to portfolio margin and cross-margin accounts. Furthermore, given the proposed risk monitoring procedures, CBOE proposes that day trading margin requirements would not apply to portfolio margin and cross-margin accounts.[15] Through these risk-monitoring procedures, member organizations will be expected to oversee portfolio margin and cross-margin accounts for excessive liquidations and day trading and take appropriate action according to their procedures.

It should be noted that the disclosure statement delivery requirement, the $5 million minimum equity requirement, and the next day deposit condition for additionally required margin were all added by the Portfolio Margin Committee. The Portfolio Margin Committee deemed these requirements prudent given that less margin is generally required under a portfolio margining approach than under the current strategy-based methodology, and these measures made the plan entirely acceptable to the member firm representatives.

g. Margin at the Clearing House Level[16]

The Exchange proposes that all customer portfolio margin account transactions not involving a futures transaction (*e.g.,* cross-margin) be cleared in one special omnibus account for the clearing firm at The OCC. In addition, the Exchange proposes that all transactions involving cross-margining, both the security and futures product, be cleared in one of two additional special omnibus accounts for cross-margining, depending on the entity that clears the futures product being cross-margined. One cross-margin omnibus account corresponds to a cross-margining agreement between The OCC, the CME and the New York Clearing Corporation. The other omnibus account corresponds to a cross-margining agreement between The OCC and the Board of Trade Clearing Corporation. The OCC will compute margin for the special omnibus accounts using the same portfolio margin methodology applied at the customer level. The OCC will continue to require full payment from the clearing firm for all long option positions. However, as previously noted, long positions will not be segregated like they are in the firm's regular customer range account at The OCC. This is necessary and preferred with a portfolio margining methodology because all long positions must be available for margin offset. Margin relief is based on a dollar offset basis as opposed to identifying specific contract to contract offsets under a strategy-based methodology. This may result in situations where the long positions of a given customer could serve to offset the risk in another customer's short position. Long positions would, therefore, be subject to The OCC lien. An OCC clearing member currently has the ability to unsegregate a long position in order to pair it with a short position (contract to contract basis) and form a qualified spread. Under the proposed treatment of long positions in a portfolio margin omnibus account at The OCC, all long positions would be unsegregated, freeing The OCC clearing member from the task of determining which long positions offset risk and from specifying each position to be unsegregated.

h. Rationale for Portfolio Margin

Portfolio margining brings a modern approach to quantifying risk and offers a number of efficiencies. It eliminates the task of analyzing the portfolio and sorting it according to currently recognized strategies (*e.g.,* spreads), and computing a margin requirement for each individual position or strategy. This process becomes quite cumbersome in an account with

[14] As disclosed in the general acknowledgement form (required of any portfolio or cross-margin customer), portfolio margin and cross-margin accounts operate pursuant to an exception to the customer protection rules in that fully paid long positions will not be segregated.

[15] The CBOE currently does not have a day-trading margin rule. Accordingly, the proposal to make day trading margin requirements inapplicable to portfolio margin and cross-margin accounts would not apply until CBOE has filed, and the Commission has approved, a proposed rule change relating to day trading margin. Telephone conversation between Richard Lewandowski, Vice President, Division of Regulatory Services, CBOE, and Hong-Anh Tran, Special Counsel, Division of Market Regulation (''Division''), Commission, on February 12, 2002. The NYSE and the National Association of Securities Dealers, Inc. (''NASD'') have day trading margin rules and the CBOE does review its member organizations as necessary for compliance with day trading rules when the member is also a NYSE member or a NASD member.

[16] The Commission anticipates that the clearing arrangements described in this section will be the subject of a separate proposed rule change filed by The OCC.

multiple positions and complex strategies. More importantly, for a given market move, up or down, in a diverse portfolio there will be listed option positions that appreciate and other option positions that will depreciate. Under a portfolio margin system, offsets are fully realized, whereas, under the current strategy-based system, positions and/or a group of positions comprising a single strategy are margined independent of each other and offsets between them do not figure into the total margin requirement as efficiently. In addition, under a portfolio margin system, the volatility of an individual listed option series is used in the theoretical pricing model that renders the price used to compute a gain/loss on that option position at each valuation point. This links the margin required to the risk in each particular position in contrast to the strategy-based margin. Strategy-based margin applies a universal percentage requirement (of the underlying index value) to all short option positions in the same category (*e.g.,* broad-based), irrespective of the fact that all options prices do not change equally (in percentage terms) with a change in the price or level of the underlying instrument.

Theoretical options pricing models have become widely accepted and utilized since Fischer Black and Myron Scholes first introduced a formula for calculating the value of a European style option in 1973.[17] Other formulas, such as the Cox-Ross-Rubinstein model have since been developed. Option pricing formulas are now used routinely by option market participants to analyze and manage risk and have proven to be highly effective and preferred. In addition, essentially the same portfolio methodology described above has been used successfully by broker-dealers since 1994 to calculate haircuts on option positions for net capital purposes.[18]

The Board of Governors of the Federal Reserve System (the ''Federal Reserve Board'' or ''FRB'') in its amendments to Regulation T in 1998 permitted SROs to implement portfolio margin rules, provided they are approved by the Commission.[19] A portfolio margin system recognizes the offsetting gains from positions that react favorably in market declines, while market rises are tempered by offsetting losses from positions that react negatively. A portfolio margin approach can thus have a neutralizing effect on option portfolio volatility. In times of market stress, the current strategy-based margin can result in margin calls and forced liquidations, thus contributing to the selling pressure in the market. The offset ability of portfolio margining can alleviate the need for liquidations, slowing acceleration of volatility in a crisis.

More recently, the FRB encouraged the development of a portfolio margin approach in a letter to the Commission and the CFTC delegating authority to the agencies to jointly prescribe margin regulations for security futures products.[20] In that letter, the FRB wrote that it ''has encouraged the development of [portfolio margin approaches] by, for example, amending its Regulation T so that portfolio margining systems approved by the Commission can be used in lieu of the strategy-based system embodied in the Board's regulation.'' The FRB concluded that letter by writing ''The Board anticipates that the creation of security future products will provide another opportunity to develop more risk sensitive, portfolio-based approaches for all securities, including security options and security futures products.''

An ability to cross-margin listed index options with index futures, and options on such futures, is critical because many professional investors hedge their listed index options with futures. Although haircuts assessed on broker-dealers with respect to computing their net capital requirement recognize offsets between securities index options and index futures, current margin practice does not allow these offsets. Cross-margin benefits the financial markets and clearing system in general, not just individual investors. Cross-margin would reduce the number of forced liquidations. Currently, an option (securities) account and futures account of the same customer are viewed as separate and unrelated. In addition, currently an option account must be liquidated if the risk in the positions has increased dramatically or margin calls cannot be met, even if gains in the customer's futures account offset the losses in the options account. If the accounts can be combined (*i.e.*, cross-margin), there is little or no net change in risk and unnecessary liquidation can be avoided. The severity of a period of high volatility in the market is lessened if the number of liquidations is reduced because, for example, liquidating into a declining market exacerbates the decline. A capability to cross-margin listed index options and index futures would further alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility, particularly in times of market downturns. Various government agencies and task groups have previously advocated implementation of a cross-margin system. Those groups include the Presidential Task Force on Market Mechanics (also known as the Brady Commission)[21] and the Commission.[22]

Listed index options are now at a disadvantage to economically equivalent derivative products traded on futures exchanges in terms of margin requirements. Since 1988, index futures and options have been margined under a portfolio margin system known as SPAN. While the risks of listed index options are no greater than an equivalent position in an index future or option on the future, margin required on listed securities index options is significantly higher in many cases. Currently, listed index options margin (excluding the option premium) for a short at-the-money contract approximates 15% of the underlying index value while SPAN margin on a comparable futures index option contract is approximately 6% of the index value. When faced with such a disparity, investment managers discerningly choose futures products over listed index options for their hedging to reduce their costs. A portfolio style margin application for listed index options will reduce disparities between securities index options and futures products, thus making listed index products more competitive and more effective tools for investors.

Relief provided by a portfolio margin system is also needed so that listed index options can compete with over-the-counter derivatives, which can be

---

[17] In 1997, Fischer Black and Myron Scholes were awarded a Nobel Prize for the development of an options pricing formula.

[18] On March 15, 1994, the Commission issued a no-action letter allowing the implementation of a risk-based haircut pilot program. *See* letter from Brandon Becker, Director, Division, Commission, to Mary Bender, First Vice President, Division of Regulatory Services, CBOE, and Timothy Hinkes, Vice President, The OCC, dated March 15, 1994. The risk-based haircut program took full effect on September 1, 1997. *See* ''Net Capital Rule,'' Securities Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

[19] *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).

[20] *See* letter from the FRB to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, Commission, dated March 6, 2001.

[21] *See* ''The Brady Report,'' Report of the Presidential Task Force on Market Mechanisms, January 1988, p. 59 and pp. 65–66.

[22] *See* ''The October 1987 Market Break: Report by the Division,'' Commission, February 1988, pp. 10–57. *See also* the interim report of the ''Working Group on Financial Markets,'' (Department of the Treasury, CFTC, Commission and FRB), May 1988, Appendix D III A.

margined on a good faith basis if hedged with a listed option.[23]

2. Statutory Basis

The Exchange believes that the proposed rule change described above is consistent with the provisions of section 6(b) of the Act,[24] in general, and specifically furthers the objectives of section 6(b)(5) of the Act,[25] in that it is designed to perfect the mechanisms of a free and open market and to protect investors and the public interest. The proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency in respect of Exchange margin requirements for complex, multiple position listed index option strategies, and to offer a cross-margin capability with related index futures positions in eligible accounts.

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

CBOE 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

No written comments were solicited or received with respect to the proposed rule change.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change, or

(B)institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

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 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 CBOE. All submissions should refer to File No. SR–CBOE–2002–03 and should be submitted by April 19, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[26]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–7609 Filed 3–28–02; 8:45 am]

BILLING CODE 8010–01–P

[23] *See* ''OTC Derivatives Dealers,'' Securities Exchange Act Release No. 40594, (October 23, 1998), 63 FR 59362 (November 3, 1998).

[24] 15 U.S.C. 78f(b).

[25] 15 U.S.C. 78f(b)(5).

[26] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45638; File No. SR–NASD–2002–36]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Certificates of Designation for Preferred Stock of the Nasdaq Stock Market, Inc.

March 25, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on March 8, 2002, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its subsidiary, the Nasdaq Stock Market, Inc. (''Nasdaq'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq is filing Certificates of Designations, Preferences and Rights (''Certificates of Designation'') of Series A Cumulative Preferred Stock (''Series A Preferred'') and Series B Preferred Stock (''Series B Preferred,'' collectively ''Series A and B Preferred'') authorized to be issued to the NASD. The Series A and B Preferred will be issued as part of a transaction designed to reduce the NASD's economic interest in Nasdaq to the greatest extent practicable while maintaining the NASD's voting control until Nasdaq begins operating as a national securities exchange. Under Section 151(g) of the General Corporation Law of the State of Delaware (''Delaware Law''), such Certificates of Designation are deemed to be an amendment to Nasdaq's Restated Certificate of Incorporation. Pursuant to Rule 19b–4(f)(3),[3] Nasdaq has designated this filing as one concerned solely with the administration of the self-regulatory organization because the authorization and issuance of the Series A and B Preferred result in no substantive change in the NASD's control of Nasdaq until exchange registration, and as such, the filing is immediately effective. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

In its filing with the Commission, Nasdaq 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. Nasdaq 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

1. Purpose

Nasdaq is filing the Certificates of Designations described below. Under Article Fourth, Paragraph B of Nasdaq's Restated Certificate of Incorporation, the Nasdaq Board may authorize the issuance of preferred stock and fix its designation, powers, preferences and

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

[2] 17 CFR 240.19b–4.

[3] 17 CFR 240.19b–4(f)(3).