



Information Circular IC07-061

Date: May 15, 2007

To: Members and Member Firms

From: Regulatory Services Division

Re: What Members Should Know About Customer Portfolio Margin

As the Membership may be aware, portfolio margining for customers became effective on April 2, 2007. The impact of portfolio margining for the options business is expected to be significantly positive, equalizing treatment of CBOE products with those of the futures markets while allowing more efficient capital usage, thus generating additional volume for the industry. While the overall impact should be positive, there is a concern that some users may choose to move from a broker-dealer category to the customer category based on an insufficient understanding of portfolio margining. The attached Question and Answer sheet and the seminars to be held later this month (see below) attempt to clarify some issues relevant to such an important decision.

Members may also submit questions via e-mail by going to the CBOE members website at www.cboe.org and clicking on the Submit Questions regarding Customer Portfolio Margin in the Spotlight portion.

Seminars

You are invited to attend a presentation on Portfolio Margin presented by the Member and Regulatory Services Division of the Chicago Board Options Exchange ("CBOE"). This presentation is designed to provide you with information and respond to questions you may have concerning Customer Portfolio Margin. Attached please find a Question and Answer sheet discussing the most common questions that we have received to date.

The presentations will be held at the CBOE on the following dates:

May 22, 2007 at 11:30-12:30 and 3:30-4:30 in the Fourth Floor Auditorium
May 30, 2007 at 3:30-4:30 in the Fourth Floor Members Lounge

As seating is limited, please confirm your attendance by contacting Christine Punicki at punickic@cboe.com or 312-786-8388. If you have additional questions or seek additional information regarding Customer Portfolio Margin, please contact James Adams (312-786-7718) or Larry Bresnahan (312-788-7713) at anytime.

Questions About Customer Portfolio Margin

These questions and answers regarding customer portfolio margin are designed to provide information to the membership. Each member must of course make decisions based on their particular facts and circumstances.

What is Portfolio Margin?

Amended and expanded customer portfolio margin rules became effective on April 2, 2007, and provide for customer margin levels, with the exception of the per contract minimum, which are equivalent to the risk-based haircut assessed to market maker transactions. These margin levels are regulatory minimums and will be computed using the following assumed market moves:

- +/- 15% for equities, equity options, narrow-based index options and security futures*
- +/- 10% for non-high capitalization broad-based indices*
- +/- 6%/8% for high capitalization broad-based indices.*

Portfolio margin positions are subject to a per contract minimum of \$37.50 (assuming a per contract multiplier of 100). (As you may be aware, a \$25.00 minimum currently applies to market-makers and broker-dealers.)

Who is Eligible for Portfolio Margin?

Eligible participants are:

- Broker-Dealers that are registered with the SEC;*
- Members of futures exchanges, to the extent listed index options are used to hedge index futures;*
- Any other person or entity approved for uncovered options.*

What products are eligible for Portfolio Margin?

Eligible positions include any margin equity security, including foreign stocks (provided there is a ready market), listed equity options, listed index options, index warrants, securities futures, unlisted derivatives and equity exchange traded funds.

Can unhedged stock be maintained in a Portfolio Margin Account?

Unhedged long or short stock can be maintained in a portfolio margin account. Such positions will be subject to a regulatory minimum margin computed using an assumed market move of +/- 15%. The self-regulatory organizations, however, require that the carrying broker-dealer have

risk monitoring capabilities, which include the imposition of higher “house” requirements as well as various stress testing scenarios and that they establish higher house requirements for more volatile, low priced or concentrated securities.

Therefore, for an unhedged portfolio, it is possible for portfolio margin requirements to exceed the risk-based haircut requirement applied to market makers and/or JBOs because the carrying broker-dealer must stress test portfolios using an assumed market move that is commensurate with the volatility of the underlying, rather than just applying the 15% minimum.

Is Cross Margin available for Portfolio Margin customers?

While the portfolio margin rules contain provisions for cross margining with index futures and options, that portion of the rule is not operable at this time. Until segregation issues between the SEC and the CFTC are resolved, the ability to combine securities and futures products into a single portfolio margin account will be unavailable.

Are offsets allowed between equity portfolios (e.g., Dell vs. HP)?

In computing the regulatory minimum, offsets are not allowed between equity classes. Carrying broker-dealers may allow offsets for purposes of “house” portfolio margin requirements. For index options, the same offsets allowed under risk-based haircuts apply.

Are stock baskets permitted in portfolio margin accounts?

Stock baskets are permitted. The same procedures followed for risk-based haircuts apply.

Can I establish and hold positions in fixed-income securities in a portfolio margin account?

Fixed-income securities may be established and held in a portfolio margin account. However, they are not eligible for portfolio margin treatment. Margin is required in accordance with the maintenance margin rules (position-based) of the exchanges. The same applies to money market mutual funds.

Is my IRA account eligible for Portfolio Margining?

IRA accounts are not eligible for portfolio margin.

Do customer day-trading requirements apply to a Portfolio Margin Customer?

Yes, day trades in a customer portfolio margin account are subject to day trading margin requirements. However, there are two exceptions. 1) If an account maintains \$5 million dollars in equity, day trading margin requirements do not apply. 2) If the security day traded is part of a hedge strategy, then day trading margin requirements do not apply. For purposes of this rule a hedge strategy means a transaction or series of transactions that reduce or offset a material

portion of the risk in a portfolio. In both exceptions, the clearing member must have the ability to monitor the intra-day risk associated with day trading.

Also, if the carrying broker-dealer has a real time margin system that rejects orders if sufficient margin is not on deposit, day trading margin requirements do not apply.

What happens if a margin call is incurred in a portfolio margin account?

Within 3 business days, cash or marginable securities must be deposited, or the customer may establish a hedge to eliminate the margin deficiency.

What happens if a margin call is not met within 3 business days?

The carrying broker-dealer is prohibited from accepting new orders that increase risk in the account and must immediately liquidate positions as necessary to eliminate the margin deficiency.

Can the customer liquidate to meet a margin call in a portfolio margin account, and are there any consequences?

The customer can liquidate positions, but exchange rules prohibit customers from a practice of liquidating to eliminate a margin deficiency. The industry considers three liquidations in a 12 month period as a practice. A liquidation would be charged whether the carrying broker-dealer or the customer undertake the liquidation. After three liquidations, it is industry practice for the carrying broker-dealer, for a period of 90 days, to require funds to be on deposit to cover the margin requirement before accepting any opening order that increases risk in the account. The carrying broker-dealer is not required to charge a liquidation if the margin deficiency is due solely to adverse price movements on existing positions.

Is there a minimum account equity requirement for a portfolio margin account?

A \$500,000 minimum account equity must be maintained if trades are executed away and not entered into the carrying broker-dealer's margin and risk system at the time of execution. For all other accounts, a \$150,000 minimum account equity must be maintained, except that, if the carrying broker-dealer has a real-time margining system that rejects orders if sufficient margin is not on deposit, a \$100,000 minimum account equity is required.