notwithstanding any affiliation between NSCC and any other entity, including any clearing agency, except as otherwise expressly provided by written agreement: (1) NSCC shall not be liable for any obligations of such other entity; (2) the participants fund or other assets of NSCC shall not be available to such other entity; (3) such other entity shall not be liable for any obligations of NSCC; and (4) any assets of such other entity shall not be available to NSCC. The Commission has approved similar revisions to DTC's rules.[5]

II. Discussion

Section 17A(b)(3)(F) of the Act[6] requires that the rules of a clearing agency assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes that the proposed rule change is consistent with NSCC's obligations under Section 17A(b)(3)(F) because it should ensure that NSCC's assets, including its clearing fund, are not diminished as a result of its affiliation with DTC.

III. Conclusion

On the basis of the foregoing, the Commission finds that NSCC's proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR–NSCC–99–07) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[7]

Jonathan G. Katz,

Secretary.

[FR Doc. 99–27599 Filed 10–21–99; 8:45 am]

BILLING CODE 8010–01–M

[5] Securities Exchange Act Release No. 42013 (October 15, 1999) [File No. SR–DTC–99–11].

[6] 15 U.S.C. 78q–1(b)(3)(F).

[7] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42011; File No. SR–NYSE–99–03]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1 and 2 by the New York Stock Exchange, Inc. Relating to NYSE Rule 431

October 14, 1999.

1. Introduction

On January 27, 1999, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and rule 19b–4 thereunder,[2] a proposed rule change to amend NYSE rule 431, ''Margin Requirements,'' to revise the margin requirements for stock options and stock index options. The proposed rule change was published for comment in the **Federal Register** on March 19, 1999.[3] The Commission received 16 comment letters regarding the proposal.[4]

The NYSE filed Amendment No. 1 to the proposal on August 11, 1999,[5] and Amendment No. 2 to the proposal on September 3, 1999.[6] This order approves the proposed rule change and grants accelerated approval to Amendment Nos. 1 and 2.

II. Description of the Proposal

A. Background

Until several years ago, the margin requirements governing listed options[7] were set forth in Regulation T, ''Credit by Brokers and Dealers.''[8] 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 options exchanges, subject to approval by the Commission.[9]

In April 1996, the Exchange established NYSE Rule 431 Committee

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 41168 (March 12, 1999), 64 FR 13620.

[4] *See* letter from William J. Brodsky, Chairman and Chief Executive Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated April 1, 1999 (''CBOE Letter''); letter from Jack L. Hansen, Senior Portfolio Manager and Principal, The Clifton Group, to Jonathan Katz, Secretary, Commission, dated March 29, 1999 (''Clifton Letter''); letter from Ronald M. Egalka, President and CEO, Rampart Investment Management, to Jonathan G. Katz, Secretary, Commission, dated March 31, 1999 (''Rampart Letter''); letter from Robert C. Sheehan, President, Robert C. Sheehan and Associates, to Jonathan Katz, Secretary, SEC, dated March 26, 1999 (''Sheehan Letter''); letter from Alvin Wilkinson to Jonathan G. Katz, Secretary, Commission, dated March 25, 1999 (''Wilkinson Letter''); letter from Stewart E. Winner, First Vice President, Director, Retail Options, Prudential Securities Inc., to Jonathan Katz, Secretary, SEC, dated March 30, 1999 (''Prudential Letter'') letter from Jeffrey T. Kaufmann, Lakeshore Securities L.P., to Jonathan Katz, Secretary, SEC, dated March 26, 1999 (''Lakeshore Letter''); letter from Gary Alan DeWaal, Executive Vice President and General Counsel, FIMAT USA, to Jonathan Katz, Secretary, SEC, dated April 8, 1999 (''FIMAT Letter''); letter from Leslie C. Quick, III, President, U.S. Clearing Corp., to Jonathan G. Katz, Secretary, SEC dated April 7, 1999 (''U.S. Clearing Letter''); letter from William C. Floersch, President and CEO, O'Connor & Company, to Jonathan G. Katz, Secretary, SEC, dated April 5, 1999 (''O'Connor Letter''); letter from Jeffrey S. Alexander, Vice President and Senior Counsel, Office of the General Counsel, Merrill Lynch, to Jonathan Katz, Secretary, SEC, dated April 8, 1999 (''Merrill Lynch Letter''), letter from Lon Gorman, Executive Vice President, Charles Schwab, to Jonathan G. Katz, Secretary, SEC, dated April 13, 1999 (''Schwab Letter''); letter from Robin Roger, Principal and Counsel, Morgan Stanley Dean Witter, to Jonathan G. Katz, Secretary SEC, dated April 16, 1999 (''Morgan Stanley Letter''); letter from R. Allan Martin, Empire Programs, Inc., to Jonathan Katz, Secretary, SEC, dated May 12, 1999 (''Empire Letter''); letter from Kevin Wiseman, Chairman of the Rules and Regulations Committee, Credit Division, Securities Industry Association (''SIA''), to Margaret H. McFarland, Deputy Secretary, SEC, dated June 15, 1999 (''SIA Letter''); and letter from George Brunelle to Jonathan Katz, Secretary, SEC, dated July 1, 1999 (''Brunelle Letter'').

[5] *See* letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard C. Strasser, Assistant Director, Division of Market Regulation (''Divison''), Commission, dated August 10, 1999 (''Amendment No. 1''). Amendment No. 1 revises the proposal to: (1) Provide that the minimum margin requirement 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 exercise price; (2) provide that the minimum margin requirement for a short put on an over-the-counter (''OTC'') option will be a specified percentage of the put's exercise price; (3) clarify that the proposal does not provide loan value for long-term foreign currency options (''FCOs''); (4) provide examples demonstrating the operation of the proposed rule in connection with various options strategies, including long box spreads, hedged puts and calls, conversions, reverse conversions, and collars; and (5) makes a technical correction to the text of the proposed rule.

[6] *See* letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard C. Strasser, Assistant Director, Division, Commission, dated September 3, 1999 (''Amendment No. 2''). Amendment No. 2 responds to the Brunelle Letter and revises the proposal to provide that butterfly and box spreads carried in the cash account must be comprised of listed options or must be guaranteed by the carrying broker-dealer.

[7] The Options Clearing Corporation (''OCC'') issues listed options.

[8] 12 CFR 220 *et seq.* The Board of Governors of the Federal Reserve System (''Federal Reserve Board'') issued Regulation T pursuant to the Act.

[9] *See* Board of Governors of the Federal Reserve System Docket No. R–0772 (April 24, 1996), 61 FR 20386 (May 6, 1996) (permitting the adoption of margin requirements ''deemed appropriate by the exchange that trades the option, subject to the approval of the Securities and Exchange Commission'').

(''431 Committee'') to review the Exchange's margin requirements. The 431 Committee is comprised of industry representatives with diverse areas of expertise. The 431 Committee created various subcommittees, including an Options Subcommittee (''Options Subcommittee''), to review specific areas of NYSE Rule 431 and make recommendations to the Exchange in light of the changes in federal margin regulations and changing industry conditions. The Options subcommittee reviewed NYSE Rule 431 and recommended changes relating to the margin treatment of options. The proposed amendments to NYSE Rule 431 are substantially identical to amendments made in a proposal filed by the Chicago Board Options Exchange, Inc. (''CBOE'', which the Commission recently approved.[10]

Specifically, the NYSE proposes to amend NYSE Rule 431 to: (1) Permit the extension of credit on certain listed and over-the-counter (''OTC'') options with over nine months until expiration and on certain long box spreads; (2) recognize butterfly and box spreads as strategies for purposes of margin treatment and establish margin requirements for them; (3) recognize various strategies involving stocks (or other underlying instruments) paired with long options, and provide for lower maintenance margin requirements on such hedged stock positions; (4) expand the types of short options positions that will be considered ''covered'' in a cash account to include certain short positions that are components of limited risk spread strategies (*e.g.*, butterfuly and box spreads); and (5) allow an escrow agreement that conforms to NYSE standards to serve in lieu of cash for certain spread positions held in a cash account. In addition, the proposal revises the margin requirement for short put options to provide that: (1) The Minimum margin requirement 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 exercise price; and (2) the minimum margin requirement for a short put on an OTC option will be a specified percentage of the put's exercise price.[11]

B. Definitions

Currently, NYSE Rule 431 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. The NYSE proposes to revise the definition to indicate that the current market value of 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.

The Exchange also proposed to establish definitions for ''butterfly spread'' [12] and ''box spread''[13] options strategies. The definitions are important elements of the Exchange's proposal to recognize and specify 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 treatment.

Finally, the NYSE proposes to define as ''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 NYSE under which a bank holding cash, cash equivalents, one or more qualified equity securities or a combination thereof 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-in.

C. Extension of Credit on Long Term Options and Warrants

The proposal will allow extensions of credit on certain long listed and OTC [14] 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.)[15] Only those options or warrants with expirations exceeding nine months (''long term'') will be eligible for credit extension.[16] For long term listed options and warrants, the proposal requires initial and maintenance margin of not less than 75% of the current market value of the option or warrant. Therefore, an NYSE member firm would be able to loan up to 25% of the current market value of a long term listed option or warrant.[17]

The proposal also permits the extension of credit on certain long term OTC options and warrants. Specifically, the proposal will allow a member firm to 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; (2) be guaranteed by the carrying broker-dealer; and (3) have an American-style exercise provision (*i.e.*, may be exercised at any time up to the day before expiration). 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.* intrinsic value), plus 100% of the amount, if any, by which the current market value of the OTC option or warrant exceeds the in-the-money amount.

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 will become 100% of the current market value. Thus, options or warrants expiring in less than nine months would have no loan value under the proposal. Options or warrants with less than nine

[10] *See* Securities Exchange Act Release No. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving File No. SR–CBOE–97–67) (''CBOE Approval Order'').

[11] *See* Amendment No. 1, *supra* note 5.

[12] 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 compound 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, (B) a ''short butterfly spread'' in which two long options in the same series offset one short option and with a higher exercise price and in one short option with a lower exercise price.

[13] 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.

[14] 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 though the automated quotation system of a registered securities association.

[15] Throughout the remainder of this approval order, the term ''warrant'' means this type of warrant.

[16] 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 current market value of the option or warrant.

[17] 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 its broker. Under the NYSE's current margin rules, the investor would be required to pay the entire $100. *See* CBOE Approval Order, *supra* note 10, at footnote 18.

months to expiration will have no loan value because of the leverage and volatility of those instruments.[18]

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

The proposal will allow the extension of credit on a long box spread comprised entirely of European-style options [19] that are listed or guaranteed by the carrying broker-dealer. A long box spread is a strategy that is 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 meeting the cost of establishing the long box spread. The two exercise prices embedded in the strategy determine the buy and the sell price.[20]

For long box spreads made up of European-style options, the proposed margin requirement would equal 50% of the aggregate difference in the two exercise prices (buy and sell), which results in a requirement slightly higher than 50% of the debit typically incurred.[21] The 50% margin requirement is both an initial and maintenance margin requirement.[22] The proposal will afford a long box spread a market value for margin equity purposes of not more than 100% of the aggregate difference in exercise prices.

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

The proposal would make butterfly spreads and box spreads in cash-settled, European-style options eligible for the cash account. 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 proposed definition section,[23] and must be comprised of options that are listed or guaranteed by the carrying broker-dealer.[24] 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 the NYSE, full payment of the debit incurred to establish a long butterfly or box spread will cover any potential risk to the carrying broker-dealer.[25]

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.[26] The maximum risk potential in a short butterfly spread comprised of call options is the aggregate difference between the two lowest exercise prices.[27] With respect to short butterfly spreads comprised of put options, the maximum risk potential 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.

Short box spreads also generate a credit balance when established. This credit is nearly equal to total debit (loss) that, in the case of a short spread, will accrue to the account if held to expiration. The proposal 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.[28] 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 to be held or deposited.[29]

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.[30] 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

[18] *See* Amendment No. 1, *supra* note 5.

[19] A European-style index option may be exercised only at its expiration pursuant to the rules of the OCC. *See* NYSE Rule 700(b)(19).

[20] 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 the Exchange'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* Amendment No. 1, *supra* note 5, and CBOE Approval Order, *supra* note 10, at footnote 22.

[21] In the example appearing 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 10, at footnote 23.

[22] *See* Amendment No. 1, *supra* note 5.

[23] *See supra* notes 12 and 13.

[24] *See* Amendment No. 2, *supra* note 6.

[25] To create a long butterfly spread, which is comprised of call options, an investor may be long 1 ZYZ Jan 45 Call @ 6, short 2 Jan 50 Calls @ 3 each, and long 1 XYZ Jan 55 Call @ 1. The maximum risk for this long butterfly spread is the net debit incurred to establish the strategy ((3 + 3) − (6 + 1) = net debit of 1). Under the proposal, therefore, the investor would be required to pay the net debit, or $100 (1 × 100). *See* CBOE Approval Order, *supra* note 10, at footnote 25.

[26] 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.

[27] 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 proposal, 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) = net credit of 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 10, at footnote 27.

[28] 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 organization such amount in the event the account is assigned an exercise notice on either short option.

[29] 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 the Exchange's proposed definition of ''short box spread'' (*supra* note 12), the buy side exercise price exceeds the sell 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 10, at footnote 29.

[30] 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.

cash, cash equivalents, or an escrow agreement equal to at least the aggregate exercise price differential.

F. Margin Account Treatment of Butterfly Spreads and Box Spreads

The Exchange's margin rules presently do not recognize butterfly spreads for margin purposes. Under the Exchange's current margin rules, the two spreads (bullish and bearish) that make up a butterfly spread each must be margined separately. The Exchange believes that the two spreads should be viewed in combination, and that commensurate with the lower combined risk, investor should receive the benefit of lower margin requirements.

The Exchange'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.[31] 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 a margin account, where all option positions making up the box spread are listed or guaranteed by the carrying broker-dealer, also are the same 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 is incurred when the spread strategy is established.[32] 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; however, 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 Requirement for Short Put Options

NYSE Rule 431(f)(2)(D) 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 the NYSE, the NYSE'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.[33] The NYSE 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, the NYSE proposes to amend NYSE Rule 431(f)(2)(D) to provide that 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 exercise price. The minimum margin required for a short OTC put option will be an amount equal to a specified percentage of the option's exercise price.[34]

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

The Exchange 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. 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 a stock position held in conjunction with an overlying option (or options), the proposal is structured to also apply to components that underlie index options and warrants. For example, these same maintenance margin requirements will apply when these strategies are utilized with a stock basket underlying index options or warrants. Proposed Exchange Rule 431(f)(2)(G)(v) will define the five strategies and set forth the respective maintenance margin requirements for the stock component of each strategy.[35]

1. Long Put/Long Stock

The Put/Long Stock 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. The maintenance margin requirement for the Long Put/Long Stock combination would be the lesser of: (i) 10 percent of the put option exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (ii) 25% of the current market value of the long stock position.[36]

2. Long Call/Short Stock

The Long Call/Short Stock 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 equivalent units of the underlying component. For a Long Call/Short Stock combination, the maintenance margin requirement would be the lesser of: (i) 10% of the call option exercise price, plus 100% of any amount by which the call option is out-of-the-money; or (ii) the maintenance margin requirement on the short stock position as specified in NYSE Rule 431(c).[37]

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[31] *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.

[32] 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 differences in the two exercise prices.

[33] *See* Amendment No. 1, *supra* note 5.

[34] *Id.*

[35] The Exchange'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 Exchange does not possess the independent authority to lower the initial margin requirement for stock. *See* CBOE Approval Order, *supra* note 10, at footnote 33.

[36] 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 $((10\% \times 50) + (100\% \times 2) = 7)$ or $(25\% \times 52 = 13)$. Therefore, the investor would be required to maintain margin equal to at least $700 ($7 \times 100$). *See* CBOE Approval Order, *supra* note 10, at footnote 34.

[37] 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 of 30% or the current market value, whichever is greater. *See* NYSE Rule 431(c). For example, for an investor who is short 100 shares of XYZ @ 48 and long 1 XYZ Jan 50 Call @ 1, the required margin would be the lesser of $((10\% \times 50) + (100\% \times 2) = 7)$ or $(30\% \times 48 = 14.4)$. Therefore, the investor would be required to maintain margin equal to at least $700 ($7 \times 100$). *See* CBOE Approval Order, *supra* note 10, at footnote 35.

3. Conversion

A ''Conversion'' is a long stock position held in conjunction with a long put and a short call. The long put and short call must have the same expiration date 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 of the long put. Regardless of any decline in market value, the stock, in effect, is worth no less than the long put exercise price.

The Exchange's current margin regulations 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 present maintenance margin requirement (*i.e.*, 25% of the current market value).[38] Under the proposal, the maintenance margin for a Conversion would be 10% of the exercise price.[39]

4. Reverse Conversion

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. The short put is covered by the short stock and the long call is a right to buy the stock at a predetermined price—the call 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 not more than the call exercise price. The maintenance margin requirement for a Reverse Conversion would be 10% of the 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).[40]

5. Collar

A ''Collar'' is a long stock position held in conjunction with a long put and a short call. A Collar differs from a Conversion in that 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 would be the lesser of: (i) 10% of the long put exercise price, plus 100% of any amount by which the long put is out-of-the-money; or (ii) 25% of the short call exercise price.[41] Under the Exchange's current margin regulations, the stock may not be valued at more than the call exercise price.

III. Summary of Comments

The Commission received 16 comment letters regarding the proposed rule change.[42] All of the commenters generally supported the proposal. One commenter noted, for example, that the NYSE's proposal would provide additional flexibility and borrowing capabilities to clients while adequately protecting carrying broker-dealers against potential risks.[43] Another commenter maintained that the proposal will align margin treatment more closely with the risk associated with a position by permitting lower margin treatment for options strategies with a defined risk.[44] The commenter also believed that the proposal will benefit customers by providing increased flexibility and lowering costs and will ''increase the viability of listed options and the competitiveness of the options markets generally.'' [45]

Noting the margin requirements for index options often are higher than the margin requirements for comparable index futures products, ten of the commenters advocated the adoption of a risk-based methodology for margining options positions.[46] One commenter asserted that some clients used index futures options rather than index options because the margin requirements for index futures options are lower and better related to the risk of the overall customer positions.[47] Another commenter, a CBOE market maker in S&P 500 Index options and a member of the CBOE's Board of Directors, stated that some market participants believe that the margin requirements for offsetting spread positions are onerous and that the current options margin requirements are a significant barrier to additional customer business.[48] A third commenter noted that listed options strategies often are disadvantaged in terms of margin treatment in comparison to comparable futures products,[49] and a fourth commenter urged the securities exchanges and regulators to modify the margin requirements for listed options to make them more comparable to the margin requirements for futures index options.[50] A fifth commenter maintained that the current margin rules preclude cross-margining between index options and futures, thereby creating artificial liquidity problems and encouraging customers to trade in the OTC market.[51]

In its comment letter, the CBOE supported the NYSE's proposal but suggested that the NYSE modify its proposal to: (1) Revise the NYSE's customer margin requirement for short equity put options to conform to the CBOE's margin requirement for short equity put options;[52] and (2) provide

[38] For example, for an investor who is long 100 shares of XYZ @ 48, long one XYZ Jan 50 Put at 2, and short one XYZ Jan 50 Call @ 1, the present maintenance margin on the long stock position would be $1,200 ((25% × 48) × 100). However, if the price of the stock increased to 60, the NYSE currently specifies 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 10, at footnote 36.

[39] For the 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 10, at footnote 37.

[40] 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 @ 2½, and short one XYZ Jan 50 Put @ 1½. If the current market value of XYZ stock drops to 30, the maintenance margin would be $2,500 ((10% × 50) + (50–30)) × 100. *See* CBOE Approval Order, *supra* note 10, at footnote 38.

[41] 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 ((10% × 45) + 3 = 7½) or (25% × 50 = 12½). Therefore, the investor would need to maintain at least $750 (7½ × 100) in margin. *See CBOE Approval Order, supra* note 10, at footnote 39.

[42] *See* note 4, *supra.*

[43] *See* Merrill Lynch Letter, *supra* note 4.

[44] *See* Schwab Letter, *supra* note 4.

[45] *Id.*

[46] *See* Letters from CBOE, Clifton, Rampart, Sheehan, Wilkinson, Prudential, Lakeshore, U.S. Clearing Corp., O'Connor, and Schwab, *supra* note 4. Two commenters noted that the futures market use a risk-based system for calculating margin requirements. *See* CBOE Letter and Lakeshore Letter, *supra* note 4.

[47] *See* Lakeshore Letter, *supra* note 4.

[48] The commenter alleged that margin requirement for certain S&P 500 Index options traded on the CBOE can be as much as two to 16 times greater than options on S&P 500 Index futures traded on the Chicago Mercantile Exchange. *See* Wilkinson Letter, *supra* note 4. Similarly, another commenter, who is a registered broker-dealer, asserted that some clients had complained that the margin requirement for certain low-risk index options positions (*e.g.*, boxes) is much greater than the risk of the position would indicate. *See* Sheehan Letter, *supra* note 4.

[49] *See* Schwab Letter, *supra* note 4.

[50] *See* Clifton Letter, *supra* note 4.

[51] *See* FIMAT Letter, *supra* note 4.

[52] CBOE Rule 12.3(c)(5) provides that the minimum customer margin required for a short put on a listed equity option is 100% of the current market value of the option or warrant plus 10% of the option or warrant's aggregate exercise price. For a short put on an OTC equity option, the minimum margin required under CBOE Rule 12.3(c)(5) is 10%

loan value for long term foreign currency options (''FCOs'').[53]

Another commenter asserted that the NYSE's proposed definition of a ''butterfly spread'' was ''technically inaccurate in a way which might impose unintended restrictions on the marginability of certain types of butterfly spreads.'' [54] The commenter suggested that the NYSE revise its definition of butterfly spread to account for long butterfly positions established over time and for fully offset butterfly spreads involving a different mix of strike prices and different numbers of options contracts.[55]

Finally, one commenter urged the Commission to confirm that the proposal, if approved, would not prevent an NYSE member from requiring additional margin from its customers as the member deemed necessary, including the margin required currently under NYSE Rule 431.[56] In addition, the commenter believed that, in light of the securities industry's efforts to ensure operational capacity to address year 2000 issues, NYSE members should not be required to make modifications to their internal systems that would be necessary to implement the proposed changes on an immediate basis.[57]

IV. Discussion

For the reasons discussed below, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change is consistent with the Section 6(b)(5) [58] requirements that the rules of an exchange 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 the Exchange's margin requirements to better reflect the risk of certain hedged options strategies.[59]

The Commission believes that it is appropriate for the Exchange 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 self-regulatory organizations (''SROs'') to adopt rules permitting the margining of options.[60] The NYSE rules approved in this order, which will permit the margining of options under the grant of authority from the Federal Reserve Board, are substantially identical to CBOE rules, which the Commission recently approved.[61]

The Commission believes that it is reasonable for the Exchange 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.[62] Because the expiration dates attached to options and warrants make such securities wasting assets by nature, it is important that the Exchange 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.[63]

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 current market value of the option or warrant. 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), plus 100% of the amount, if any, by which the current market value of the OTC option or warrant exceeds the in-the-money amount. 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 Exchange 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 Exchange'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 Exchange 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.[64] Moreover, some creditor, such as the OCC, extend credit on options as part of their current business.[65] The Commission believes

of the option's aggregate exercise price. The SIA and Prudential also recommended that the NYSE follow the CBOE's margin requirement for short equity put options. *See* SIA Letter and Prudential Letter, *supra* note 4.

[53] After submitting its comment letter, the CBOE revised its options margin proposal to eliminate the provision allowing loan value for FCOs. *See* Letter from Mary L. Bender, Senior Vice President and Chief Regulatory Officer, Division of Regulatory Services, CBOE, to Michael A. Walinskas, Deputy Associate Director, Division, Commission, dated May 14, 1999 (Amendment No. 2 to File No. SR–CBOE–97–67). Accordingly, neither the NYSE nor the CBOE will permit loan value for FCOs.

[54] *See* Brunelle Letter, *supra* note 4.

[55] In particular, the commenter maintained that ''a long butterfly spread should be defined as an aggregate position where, if any of the short positions were assigned, the holder could exercise the appropriate long positions to cover the assignment.'' *Id*.

[56] *See* Morgan Stanley Letter, *supra* note 4.

[57] In addition, the commenter maintained that NYSE members should have the opportunity to avoid making any systems modifications after the approval of the proposal to the extent that the member elects to continue operating under the NYSE's current margin rules. *Id*.

[58] 15 U.S.C. 78f(b)(5).

[59] In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78f(c)(f).

[60] *See* Board of Governors of the Federal Reserve System Docket No. R–0772 (April 24, 1996), 61 FR 20386 (May 6, 1996), and 12 CFR 220.12(f).

[61] *See* CBOE Approval Order, *supra* note 10.

[62] 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.

[63] For similar reasons, the Commission believes that it is appropriate for the Exchange 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.

[64] 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).

[65] 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

Continued

that because options 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.[66] The Commission understands that the current bar preventing broker-dealers from extending credit on options may place some NYSE member firms at a competitive disadvantage relative to other financial service firms. By permitting Exchange members to extend credit on long term options and warrants, the proposal should enable Exchange members to better serve customers and offer additional financing alternatives.

The Commission believes that it is appropriate for the Exchange 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 Exchange 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 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 Exchange'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.[67] 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 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 the Exchange to revise the maintenance margin requirements for several hedging strategies that combine stock positions with options positions. The Commission recognizes that heding 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 the Long/Put/Long Stock combination currently is margined without regard to the 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: (i) 10% of the put option exercise price, plus 100% of any amount by which the put option is out-of-the-money; or (ii) 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.[68] The Commission believes that reduced maintenance margin requirements for the stock components of hedging strategies are reasonable given the limited risk profile of the strategies.

The Commission notes that the proposed changes were reviewed carefully by the 431 Committee and the Options Subcommittee, which is comprised of industry participants who have extensive experience in margin and credit matters. In addition, as noted above, the NYSE's proposal is substantially identical to a CBOE proposal, which the Commission has approved.[69] 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 margins as it relates to price movements in the underlying securities and index components.[70] Therefore, the Commission is confident that the

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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 10.

[66] *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 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.'')

[67] 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.

[68] 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% × 50) + (100% × 2) =7) or 25% × 52 = 13). In contrast, the current margin requirement would be \$1,300, a difference of \$600. *See* CBOE Approval Order, *surpa* note 10, at footnote 63.

[69] *See* CBOE Approval Order, *supra*, note 10.

[70] *Id*.

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 Exchange member may freely implement margin requirements that exceed the margin requirements adopted by the Exchange.[71] The Commission recognizes that the Exchange's margin requirements serve as non-binding benchmarks, and that Exchange members often establish different margin requirements for their customers based on a number of factors, including market volatility. The Commission encourages Exchange members to continue to perform independent and rigorous analyses when determining prudent levels of margin for customers.

The Commission also believes that it is reasonable for the Exchange 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 treatment. The Commission believes that it is important for the Exchange to clearly define which options strategies are eligible for the proposed margin treatment.

In response to the Brunelle Letter, which recommended that the NYSE adopt a more expansive definition of ''butterfly spread,'' the NYSE noted that the 431 Committee thoroughly reviewed a wide range of spread transactions in compiling its recommendations of strategies to include in the proposal.[72] According to the NYSE, the 431 Committee decided to limit its recommendation to less complex, readily identifiable strategies. The NYSE maintains that the commenter's broader definition of butterfly spread does not meet the 431 Committee's criteria. However, the NYSE stated that it would consider the practicality of including more sophisticated strategies if there is sufficient industry interest.[73]

The Commission believes that the NYSE's approach is reasonable. The NYSE's proposed definition of a butterfly spread is consistent with the definition adopted by the CBOE[74] and, accordingly, will establish consistent rules for joint NYSE/CBOE members. In addition, the NYSE and CBOE definitions of butterfly spread reflect the consensus reached by the 431 Committee and the Options Subcommittee, which, as noted above, are comprised of industry participants with extensive experience in margin and credit matters. The Commission also believes that the NYSE's approach will allow the Exchange to gain experience in monitoring the new margin requirements in connection with less complex strategies before considering whether to include more sophisticated strategies. Accordingly, the Commission believes that it is reasonable for the NYSE to retain its proposed definition of butterfly spread.

The Commission also believes that it is reasonable for the NYSE to revise its definition of ''current market value'' and ''current market price'' in NYSE Rule 431(f)(2)(C) to conform to Regulation T. A linkage to the Regulation T definition should keep the Exchange's definition equivalent to Regulation T without requiring a rule filing if the Federal Reserve Board revises its definition of Regulation T. In addition, the Commission believes that it is reasonable for the NYSE to define an ''escrow agreement'' to establish clear requirements for an escrow agreement.[75]

In response to the CBOE's comments regarding short equity put options, the NYSE proposed in Amendment No. 1 to modify NYSE Rule 431(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 exercise price. The minimum customer margin requirement for a short put on an OTC equity will be 10% of the put's exercise price. The change proposed in Amendment No. 1 will make the NYSE's treatment of short equity put options consistent with the CBOE's treatment of short equity put options.[76] Accordingly, the proposed change in the NYSE's margin requirement for short listed and OTC equity put options raises no new regulatory issues and provides for consistent treatment of short equity put options under the rules of the NYSE and the CBOE.

The revisions to the Exchange's margin rules will significantly impact the way Exchange members calculate margin for options customers. The Commission believes that it is important for the Exchange 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 January 20, 2000 or such date the Exchange represents in writing to the Commission that the Exchange is prepared to fully implement and monitor the approved margin requirements.

The Commission expects the Exchange to issue an information memorandum 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 the Exchange 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 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 the NYSE's proposal by revising the margin requirement for short listed and OTC equity put options to make the NYSE's rule consistent with CBOE Rule 12.3(c)(5). Because this change conforms the NYSE's rule to an existing CBOE rule, which was approved by the Commission, the change raises no new regulatory issues. In addition, this provision will benefit options market participants by providing consistent treatment of short equity put options under the rules of the NYSE and the CBOE. Amendment No. 1 also clarifies the NYSE's proposal by making a technical correction and providing examples of the operation of the proposed rule in connection with various options strategies.

Amendment No. 2 strengthens the NYSE's proposal by providing that butterfly and box spreads carried in the cash account must be comprised of listed options or OTC options

[71] In this regard, the Commission notes that NYSE Rule 431(d), ''Additional Margin,'' requires NYSE member to: (1) Review limits and types of credit extended to all customers; (2) formulate their own margin requirements; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by NYSE Rule 431 for individual securities or customer accounts.

[72] *See* Amendment No. 2, *supra* note 6.

[73] *Id.*

[74] *See* CBOE Approval Order, *supra* note 10.

[75] The proposal defines an 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 forum acceptable to the NYSE under which a bank holding cash, cash equivalents, one or more qualified equity securities or a combination thereof 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-in.

[76] *See* CBOE Rule 12.3(c)(5).

guaranteed by the carrying broker-dealer. This change conforms the NYSE's proposal to the CBOE proposal approved previously by the commission.

Based on the above, the Commission finds that good cause exists, consistent with Section 19(b) of the Act,[77] to accelerate approval of Amendment Nos. 1 and 2 to the proposed rule change.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 2, including whether 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 NYSE. All submissions should refer to file number SR–NYSE–99–03 and should be submitted by November 12, 1999.

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[78] that the proposed rule change (SR–NYSE–99–03), as amended, is approved. The approved margin requirements shall become effective the earlier of January 20, 2000 or such date the Exchange represents in writing to the Commission that the Exchange is prepared to fully implement and monitor the approved margin requirements.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[79]

Jonathan G. Katz,

Secretary.

[FR Doc. 99–27601 Filed 10–21–99; 8:45 am]

BILLING CODE 8010–01–M

[77] 15 U.S.C. 78s(b).

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

[79] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42006; File No. SR–PHLX–99–36]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Permanent Approval of the X.Station Enhancement to the Electronic Order Book on the Options Floor

October 13, 1999.

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 September 3, 1999, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items, I, II, and III below, which Items have been prepared by the Exchange.[3] 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

Phlx proposes to adopt the X.Station enhancement to the electronic order book on the options floor on a permanent basis.

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

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

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

[2] 17 CFR 240.19b–4.

[3] Amendment No. 1, which was filed on October 7, 1999, provided a nonsubstantive discussion about the success of the X.Station enhancement. *See* Letter to Mike Walinskas, Associate Director, Division of Market Regulation (''Division''), SEC, from Nandita Yagnik, Attorney, Phlx, dated September 30, 1999.

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

1. Purpose

On May 7, 1998, the Commission approved, on a pilot basis, the implementation of the X.Station enhancement to the electronic order book on the options floor of the Phlx.[4] The pilot was extended twice and will expire on October 23, 1999.[5] As described in Rule 1080, Commentary .02, the electronic order book is an automated mechanism for specialists to hold and display orders based on price/time priority. The X.Station enhancement[6] provides certain improvements to the electronic order book such as expedited non-AUTO–X order execution and expedited cancel replacement processing.

AUTO–X is the automatic execution feature of the Automated Options Market System, the electronic order delivery and routing system for options orders. Previously, AUTO–X orders were executed against a ''shadow account'' for which the specialist was ultimately responsible. The execution was immediately reported back to the sending firm, and then, the specialist manually input the contra-side interest representing the booked order that became due as a result of the AUTO–X trade.

At this time, the Exchange proposes to adopt the X.Station enhancement on a permanent basis. The X.Station enhancement to the electronic order book matches incoming AUTO–X orders with booked orders by allowing the specialist to match two participants directly, without the specialist participating in the trade, by dropping the order to manual status.[7] The match is not automatic; the specialist drops the order to a manual status in order for the

[4] Security Exchange Act Release No. 39972 (May 7, 1998), 63 FR 26666 (May 13, 1998).

[5] Securities Exchange Act Release Nos. 40625 (November 2, 1998), 63 FR 60435 (November 9, 1998) and 41323 (April 22, 1999), 64 FR 23378 (April 30, 1999).

[6] The X.Station enhancement has been deployed floor-wide.

[7] The X.Station enhancement only applies to incoming AUTO–X orders on the electronic order book that are due a fill (*e.g.,* if an order is touching the book). All other AUTO–X orders are automatically executed through the wheel. When an AUTO–X order is due on the electronic order book, the order will flash red, notifying the specialist. The specialist then clicks on the order, dropping the order to manual status. Finally, the specialist fills the order from the crowd, if required by the parity/priority rules, or fills the order with the matching order from the electronic order book. Telephone conversation between Nandita Yagnik, Attorney Phlx, and Heather Traeger, Attorney, Division, SEC (October 13, 1999).