

Proposed Rule Change by National Association of Securities Dealers  
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

|   |                                    |                                     |   |   |  |
|---|------------------------------------|-------------------------------------|---|---|--|
| Initial <input checked="" type="checkbox"/>                             | Amendment <input type="checkbox"/> | Withdrawal <input type="checkbox"/> | Section 19(b)(2) <input type="checkbox"/> | Section 19(b)(3)(A) <input checked="" type="checkbox"/> | Section 19(b)(3)(B) <input type="checkbox"/> |
| Pilot <input type="checkbox"/>  |                                    |                                     | Rule                                      |   |  |
| Extension of Time Period for Commission Action <input type="checkbox"/> |                                    |                                     | <input type="checkbox"/> 19b-4(f)(1)      | <input type="checkbox"/> 19b-4(f)(4)                    |  |
| Date Expires <input type="text"/>                                       |                                    |                                     | <input type="checkbox"/> 19b-4(f)(2)      | <input type="checkbox"/> 19b-4(f)(5)                    |  |
|   |                                    |                                     | <input type="checkbox"/> 19b-4(f)(3)      | <input checked="" type="checkbox"/> 19b-4(f)(6)         |  |

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|---|---|
| Exhibit 2 Sent As Paper Document <input type="checkbox"/> | Exhibit 3 Sent As Paper Document <input type="checkbox"/> |
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**Description**  
Provide a brief description of the proposed rule change (limit 250 characters).

**Contact Information**  
Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name  Last Name   
 Title   
 E-mail   
 Telephone  Fax

**Signature**  
Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date   
 By  Senior Vice President and Deputy General Counsel  
 (Name) (Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 2520 to permit members to margin certain products according to a prescribed portfolio margin methodology on a pilot basis. NASD further proposes to amend NASD Rule 2860 to require that a disclosure statement and written acknowledgement for use with the proposed portfolio margin program be furnished to customers using a portfolio margin account.

The text of the proposed rule change is attached as Exhibit 5 to this rule filing.

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on February 1, 2006, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on February 2, 2006. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the

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

NASD By-Laws permits the Board of Governors of NASD to adopt amendments to NASD Rules without recourse to the membership for approval.

NASD has filed the proposed rule change for immediate effectiveness. The implementation date will be April 2, 2007. The proposed rule change will operate on a pilot basis starting on April 2, 2007 and ending July 31, 2007, unless the SEC approves an extension of the pilot or adoption of the program on a permanent basis.

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

(a) Purpose

**Background**

Section 7(a) of the Act<sup>2</sup> authorizes the Board of Governors of the Federal Reserve System to prescribe the rules and regulations regarding credit that may be extended by broker-dealers on securities to their customers as set forth in Regulation T. Currently, Rule 2520 (Margin Requirements) prescribes minimum maintenance margin requirements for customer accounts held by members based on position or strategy-based margin requirements. This methodology applies prescribed margin percentage requirements to each security position and/or strategy, either long or short, held in a customer's account.

The Board of Governors of the Federal Reserve System in its amendments to Regulation T in 1998 permitted self-regulatory organizations to implement portfolio

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<sup>2</sup> 15 U.S.C. 78g.

margin rules, subject to Commission approval.<sup>3</sup> Accordingly, NASD is filing the proposed rule change to allow members to extend a portfolio margin methodology to eligible participants as an alternative to the current strategy-based margin requirements.

As further detailed herein, the proposed rule change would amend NASD Rule 2520 on a pilot basis to allow members, subject to specified conditions, to elect to apply a portfolio margin methodology to all margin equity securities,<sup>4</sup> listed options, security futures products,<sup>5</sup> unlisted derivatives,<sup>6</sup> warrants, index warrants, and related instruments.<sup>7</sup> In addition, a member, provided that it is a Futures Commission Merchant (“FCM”) and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, would be permitted to combine an eligible participant’s related instruments with listed index options, unlisted derivatives, options on exchange traded funds (“ETF”), index warrants, and underlying

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<sup>3</sup> See Federal Reserve System, “Securities Credit Transactions; Borrowing By Broker and Dealers”; Regulations G, T, U and X; Dockets Nos. R-0905, R-0923 and R-0944, 63 FR 2806 (January 16, 1998).

<sup>4</sup> For purposes of the rule, the term “margin equity security” uses the definition at Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.

<sup>5</sup> For purposes of the rule, “security futures product” uses the definition at Section 3(a)(56) of the Act.

<sup>6</sup> For purposes of the rule, the term “unlisted derivatives” is defined in Rule 2520(g)(2)(H).

<sup>7</sup> For purposes of the rule, the term “related instrument” is defined in Rule 2520(g)(2)(D).

instruments<sup>8</sup> and compute a margin requirement for such combined products on a portfolio margin basis.

The proposed rule change is substantially similar to recent margin rule amendments by the New York Stock Exchange (“NYSE”) and the Chicago Board Options Exchange (“CBOE”), which were approved by the Commission.<sup>9</sup> Consistent with the NYSE and CBOE programs, the proposed rule change would be available as a pilot beginning on April 2, 2007 and ending on July 31, 2007, unless the SEC approves an extension of the pilot or adoption of the program on a permanent basis.

### **Portfolio Margin**

Portfolio margining is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a product class or group<sup>10</sup> using computer modeling to perform risk analysis using multiple pricing scenarios. These scenarios are designed to measure the theoretical loss of the positions

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<sup>8</sup> For purposes of the rule, the term “underlying instrument” is defined in Rule 2520(g)(2)(G).

<sup>9</sup> See Securities Exchange Act Release No. 54918 (December 12, 2006), 71 FR 75790 (December 18, 2006) (SR-NYSE-2006-13, relating to further amendments to the NYSE’s portfolio margin pilot program); Securities Exchange Act Release No. 54125 (July 11, 2006), 71 FR 40766 (July 18, 2006) (SR-NYSE-2005-93, relating to amendments to the NYSE’s portfolio margin pilot program); Securities Exchange Act Release No. 52031 (July 14, 2005) 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19, relating to the NYSE’s original portfolio margin pilot). See also Securities Exchange Act Release No. 54919 (December 12, 2006), 71 FR 75781 (December 18, 2006) (SR-CBOE-2006-014, relating to amendments to the CBOE’s portfolio margin pilot); Securities Exchange Act Release No. 52032 (July 14, 2005) 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03, relating to the CBOE’s original portfolio margin pilot).

<sup>10</sup> Products would be grouped into a single portfolio that is based on the same index or issuer.

given changes in both the underlying price and implied volatility inputs to the model.

Accordingly, the margin required is based on the greatest loss that would be incurred in a portfolio if the value of its components move up or down by a predetermined amount.

### **Margin Calculation**

Under the proposed rule change, a gain or loss on each position in the portfolio would be calculated on each of ten equidistant points along a range representing a potential percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. For portfolios of only highly capitalized broad-based indexes, the range would be between a market increase of 6% and a decrease of 8%. For non-highly capitalized broad-based indexes the range would be +/- 10%. For portfolios of equity options, narrow-based index options and/or security futures, the risk-array for computing the portfolio margin requirement would be up/down market moves of +/-15%.

Options having the same underlying security (or index in the case of an index option), the underlying security itself, and any related futures, options on futures or security futures products could be combined as a portfolio for purposes of computing a portfolio margin requirement. The Commission approved theoretical options pricing model would be used to derive position values at each valuation point for the purpose of determining the gain or loss.<sup>11</sup> The gains and losses are netted to derive a potential portfolio gain or loss for the point. The margin requirement for the portfolio is the amount of the greatest loss among the calculation points. Certain portfolios would be allowed offsets such that, at the same valuation point, a gain in one portfolio may reduce

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<sup>11</sup> Currently, the only model that is approved by the Commission is The Options Clearing Corporation's Theoretical Intermarket Margining System (TIMS).

or offset the loss in another portfolio. The amount of offset allowed between portfolios would be the same as permitted under SEC Rule 15c3-1a for computing a broker-dealer's net capital. The margin requirement for each portfolio would then be added together to calculate the total margin requirement for the portfolio margin account.

In addition, the proposed rule change prescribes a minimum margin requirement of \$.375 for each listed option, unlisted derivative, security futures product, and related instrument multiplied by the contract or instrument's multiplier. This minimum amount of margin ensures that a certain level of margin is required from the customer in the event that the greatest loss among the valuation points is a de minimis amount.

Generally, a customer benefits from portfolio margining in that margin requirements calculated on net position risk are generally lower than strategy-based margin methodologies currently in place. In permitting margin computation based on actual net risk, members would no longer be required to compute a margin requirement for each individual position or strategy in a customer's account.

### **Monitoring and Risk Management**

However, as a pre-condition to permitting portfolio margining, the member would be required to establish comprehensive written risk analysis methodology to assess the potential risk to the member's capital over a specified range of possible market movements. In performing the risk analysis, the member would be required to include in the written risk analysis methodology procedures and guidelines for (1) obtaining and reviewing account documentation and financial information to assess the amount of credit to be extended to eligible participants; (2) the determination, review, and approval of credit limits to each eligible participant, and across all eligible participants, utilizing a

portfolio margin account; (3) monitoring credit risk exposure to the member's capital, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management; (4) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate; (5) the regular review and testing of the procedures by an independent unit; (6) managing the impact of credit extended related to portfolio margin accounts on the member's overall risk exposure; (7) the appropriate response by management when credit extensions have been exceeded; and (8) determining when additional margin may need to be collected.

Members would be required to periodically review their credit extension activities for consistency with their guidelines and determine if the data necessary to apply portfolio margining is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data. The risk analysis methodology must be filed with NASD, or the member's designated examining authority ("DEA") if other than NASD, and submitted to the Commission prior to implementation of portfolio margining. The proposed rule change also requires members to notify and receive approval from NASD or the member's DEA if other than NASD, prior to establishing a portfolio margin methodology for eligible participants.

### **Eligible Participants**

The proposed rule change would permit the following persons to engage in portfolio margining: (1) any broker or dealer registered pursuant to Section 15 of the Act; (2) any member of a national futures exchange to the extent that listed index options, unlisted derivatives, options on ETFs, index warrants or underlying instruments hedge

the member's index futures; and (3) any person approved to engage in uncovered option contracts, and if security futures are to be included in the account, approval for such transactions is also required. However, an eligible participant under category (3) may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member. If the account of a participant subject to the five million dollar requirement falls below such minimum requirement, it must be restored within three business days. A member would be prohibited from accepting new opening orders beginning on the fourth business day, except for new opening orders entered solely for the purpose of reducing market risk, where the result would be to lower margin requirements.

### **Margin Deficiencies**

Under the proposed rule change, participants would be required to satisfy a margin deficiency in a portfolio margin account within three business days by the deposit of additional funds and/or securities or by the establishment of a hedge that would reduce margin requirements. In the event the deficiency is not satisfied after three business days, the member must liquidate positions to eliminate the deficiency. A member would be required to deduct from its net capital the amount of any margin deficiency not satisfied by the close of business on the next business day after the business day on which the deficiency arises and continuing until the deficiency is satisfied. Members should not permit an eligible participant to make a practice of meeting a portfolio margin deficiency by liquidation and would be required to identify accounts that periodically liquidate positions to eliminate margin deficiencies.

### **Establishing Account**

Members would be permitted to use a specific securities margin account or a sub-account of a margin account clearly identified as a portfolio margin account. The account must be separate from any other securities account. In the event a portfolio margin account is a subaccount of a regular margin account, a member would be allowed to use excess equity in the regular margin account to meet a margin deficiency in the portfolio margin account. In addition, securities, including money market funds, that are not eligible for portfolio margin treatment would be allowed to be carried in a portfolio margin account for their collateral value, subject to the margin requirement applicable in a regular securities margin account.

### **Day Trading**

The day trading restrictions in Rule 2520 would not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided that a member has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity would otherwise be subject to the day trading restrictions. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions would not apply. A “hedge strategy” for purposes of the rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Members would be expected to monitor portfolio accounts to detect and prevent circumvention of the day trading requirements.

### **Net Capital Treatment**

The proposed rule change would provide that the aggregate portfolio margin and maintenance requirements may not exceed ten times the member's Net Capital, as computed under SEC Rule 15c3-1. This requirement places a ceiling on the amount of portfolio margin a broker-dealer can extend to its customers.

### **Disclosure Document**

NASD Rule 2860(b)(11) prescribes requirements for the delivery of options disclosure documents concerning the opening of customer accounts. Under the proposed rule change, members would be required to provide every portfolio margin customer with a written risk disclosure statement at or prior to the initial transaction in a portfolio margin account. The disclosure would be in a format prescribed by NASD or in a format developed by the member, provided it contains substantially similar information as in the prescribed NASD format and has received the prior written approval of NASD. NASD will issue a Notice to Members to set forth the language required in the written disclosure statement.

As noted in Item 2 of this filing, NASD has filed the proposed rule change for immediate effectiveness. As noted above, the proposed rule change would establish a pilot program that would begin on April 2, 2007 and end on July 31, 2007 to conform to the time periods of the similar portfolio margin pilot programs of the NYSE and CBOE.

#### **(b) Statutory Basis**

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>12</sup> which requires, among other things, that NASD rules be

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<sup>12</sup> 15 U.S.C. 78o-3(b)(6).

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change will better align the margin requirements with actual risk.

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

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

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

Written comments were neither solicited nor received.

**6. Extension of Time Period for Commission Action**

Not applicable.

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

The proposed rule change is effective upon filing pursuant to Section 19(b)(3) of the Act and paragraph (f)(6) of Rule 19b-4 thereunder,<sup>13</sup> in that the proposed rule change does not significantly affect the protection of investors or the public interest; does not impose any significant burden on competition; and does not become operative for 30 days after filing. In accordance with Rule 19b-4,<sup>14</sup> NASD submitted written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing. The implementation date will be April 2, 2007.

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<sup>13</sup> 17 CFR 240.19b-4.

<sup>14</sup> 17 CFR 240.19b-4.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

The proposed rule change is substantially similar to NYSE Rule 431(g) (Margin Requirements) and Rule 726(d) (Delivery of Options Disclosure Document and Prospectus — Portfolio Margining Disclosure Statement and Acknowledgement) and CBOE Rule 12.4 (Portfolio Margin), 9.15(c) (Delivery of Current Options Disclosure Documents and Prospectus), 13.5 (Customer Portfolio Margin Accounts) and 15.8A (Risk Analysis of Portfolio Margin Accounts).

**9. Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 5. Revised text of the proposed rule change to Rules 2520 and 2860 marked to show additions to and deletions from the current rule language.

**EXHIBIT 1**

**SECURITIES AND EXCHANGE COMMISSION**

(Release No. 34- ; File No. SR-NASD-2007-013)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Portfolio Margin

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”) 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 NASD. NASD has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,<sup>3</sup> which renders the proposal effective upon receipt of this filing by the Commission. 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**

NASD is proposing to amend NASD Rule 2520 to permit members to margin certain products according to a prescribed portfolio margin methodology on a pilot basis. NASD further proposes to amend NASD Rule 2860 to require that a disclosure statement

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

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

<sup>3</sup> 17 CFR 240.19b-4.

and written acknowledgement for use with the proposed portfolio margin program be furnished to customers using a portfolio margin account.

The text of the proposed rule change is attached as Exhibit 5 to this rule filing.

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

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD 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

**Background**

Section 7(a) of the Act<sup>4</sup> authorizes the Board of Governors of the Federal Reserve System to prescribe the rules and regulations regarding credit that may be extended by broker-dealers on securities to their customers as set forth in Regulation T. Currently, Rule 2520 (Margin Requirements) prescribes minimum maintenance margin requirements for customer accounts held by members based on position or strategy-based margin requirements. This methodology applies prescribed margin percentage requirements to each security position and/or strategy, either long or short, held in a customer's account.

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<sup>4</sup> 15 U.S.C. 78g.

The Board of Governors of the Federal Reserve System in its amendments to Regulation T in 1998 permitted self-regulatory organizations to implement portfolio margin rules, subject to Commission approval.<sup>5</sup> Accordingly, NASD is filing the proposed rule change to allow members to extend a portfolio margin methodology to eligible participants as an alternative to the current strategy-based margin requirements.

As further detailed herein, the proposed rule change would amend NASD Rule 2520 on a pilot basis to allow members, subject to specified conditions, to elect to apply a portfolio margin methodology to all margin equity securities,<sup>6</sup> listed options, security futures products,<sup>7</sup> unlisted derivatives,<sup>8</sup> warrants, index warrants, and related instruments.<sup>9</sup> In addition, a member, provided that it is a Futures Commission Merchant (“FCM”) and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, would be permitted to combine an eligible participant’s related instruments with listed index options, unlisted derivatives, options on exchange traded funds (“ETF”), index warrants, and underlying

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<sup>5</sup> See Federal Reserve System, “Securities Credit Transactions; Borrowing By Broker and Dealers”; Regulations G, T, U and X; Dockets Nos. R-0905, R-0923 and R-0944, 63 FR 2806 (January 16, 1998).

<sup>6</sup> For purposes of the rule, the term “margin equity security” uses the definition at Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.

<sup>7</sup> For purposes of the rule, “security futures product” uses the definition at Section 3(a)(56) of the Act.

<sup>8</sup> For purposes of the rule, the term “unlisted derivatives” is defined in Rule 2520(g)(2)(H).

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instruments<sup>10</sup> and compute a margin requirement for such combined products on a portfolio margin basis.

The proposed rule change is substantially similar to recent margin rule amendments by the New York Stock Exchange (“NYSE”) and the Chicago Board Options Exchange (“CBOE”), which were approved by the Commission.<sup>11</sup> Consistent with the NYSE and CBOE programs, the proposed rule change would be available as a pilot beginning on April 2, 2007 and ending on July 31, 2007, unless the SEC approves an extension of the pilot or adoption of the program on a permanent basis.

### **Portfolio Margin**

Portfolio margining is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a product class or group<sup>12</sup> using computer modeling to perform risk analysis using multiple pricing scenarios. These scenarios are designed to measure the theoretical loss of the positions

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<sup>10</sup> For purposes of the rule, the term “underlying instrument” is defined in Rule 2520(g)(2)(G).

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<sup>12</sup> Products would be grouped into a single portfolio that is based on the same index or issuer.

given changes in both the underlying price and implied volatility inputs to the model.

Accordingly, the margin required is based on the greatest loss that would be incurred in a portfolio if the value of its components move up or down by a predetermined amount.

### **Margin Calculation**

Under the proposed rule change, a gain or loss on each position in the portfolio would be calculated on each of ten equidistant points along a range representing a potential percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. For portfolios of only highly capitalized broad-based indexes, the range would be between a market increase of 6% and a decrease of 8%. For non-highly capitalized broad-based indexes the range would be +/- 10%. For portfolios of equity options, narrow-based index options and/or security futures, the risk-array for computing the portfolio margin requirement would be up/down market moves of +/-15%.

Options having the same underlying security (or index in the case of an index option), the underlying security itself, and any related futures, options on futures or security futures products could be combined as a portfolio for purposes of computing a portfolio margin requirement. The Commission approved theoretical options pricing model would be used to derive position values at each valuation point for the purpose of determining the gain or loss.<sup>13</sup> The gains and losses are netted to derive a potential portfolio gain or loss for the point. The margin requirement for the portfolio is the amount of the greatest loss among the calculation points. Certain portfolios would be

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allowed offsets such that, at the same valuation point, a gain in one portfolio may reduce or offset the loss in another portfolio. The amount of offset allowed between portfolios would be the same as permitted under SEC Rule 15c3-1a for computing a broker-dealer's net capital. The margin requirement for each portfolio would then be added together to calculate the total margin requirement for the portfolio margin account.

In addition, the proposed rule change prescribes a minimum margin requirement of \$.375 for each listed option, unlisted derivative, security futures product, and related instrument multiplied by the contract or instrument's multiplier. This minimum amount of margin ensures that a certain level of margin is required from the customer in the event that the greatest loss among the valuation points is a de minimis amount.

Generally, a customer benefits from portfolio margining in that margin requirements calculated on net position risk are generally lower than strategy-based margin methodologies currently in place. In permitting margin computation based on actual net risk, members would no longer be required to compute a margin requirement for each individual position or strategy in a customer's account.

### **Monitoring and Risk Management**

However, as a pre-condition to permitting portfolio margining, the member would be required to establish comprehensive written risk analysis methodology to assess the potential risk to the member's capital over a specified range of possible market movements. In performing the risk analysis, the member would be required to include in the written risk analysis methodology procedures and guidelines for (1) obtaining and reviewing account documentation and financial information to assess the amount of credit to be extended to eligible participants; (2) the determination, review, and approval

of credit limits to each eligible participant, and across all eligible participants, utilizing a portfolio margin account; (3) monitoring credit risk exposure to the member's capital, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management; (4) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate; (5) the regular review and testing of the procedures by an independent unit; (6) managing the impact of credit extended related to portfolio margin accounts on the member's overall risk exposure; (7) the appropriate response by management when credit extensions have been exceeded; and (8) determining when additional margin may need to be collected.

Members would be required to periodically review their credit extension activities for consistency with their guidelines and determine if the data necessary to apply portfolio margining is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data. The risk analysis methodology must be filed with NASD, or the member's designated examining authority ("DEA") if other than NASD, and submitted to the Commission prior to implementation of portfolio margining. The proposed rule change also requires members to notify and receive approval from NASD or the member's DEA if other than NASD, prior to establishing a portfolio margin methodology for eligible participants.

### **Eligible Participants**

The proposed rule change would permit the following persons to engage in portfolio margining: (1) any broker or dealer registered pursuant to Section 15 of the Act; (2) any member of a national futures exchange to the extent that listed index options,

unlisted derivatives, options on ETFs, index warrants or underlying instruments hedge the member's index futures; and (3) any person approved to engage in uncovered option contracts, and if security futures are to be included in the account, approval for such transactions is also required. However, an eligible participant under category (3) may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member. If the account of a participant subject to the five million dollar requirement falls below such minimum requirement, it must be restored within three business days. A member would be prohibited from accepting new opening orders beginning on the fourth business day, except for new opening orders entered solely for the purpose of reducing market risk, where the result would be to lower margin requirements.

### **Margin Deficiencies**

Under the proposed rule change, participants would be required to satisfy a margin deficiency in a portfolio margin account within three business days by the deposit of additional funds and/or securities or by the establishment of a hedge that would reduce margin requirements. In the event the deficiency is not satisfied after three business days, the member must liquidate positions to eliminate the deficiency. A member would be required to deduct from its net capital the amount of any margin deficiency not satisfied by the close of business on the next business day after the business day on which the deficiency arises and continuing until the deficiency is satisfied. Members should not permit an eligible participant to make a practice of meeting a portfolio margin deficiency by liquidation and would be required to identify accounts that periodically liquidate positions to eliminate margin deficiencies.

### **Establishing Account**

Members would be permitted to use a specific securities margin account or a sub-account of a margin account clearly identified as a portfolio margin account. The account must be separate from any other securities account. In the event a portfolio margin account is a subaccount of a regular margin account, a member would be allowed to use excess equity in the regular margin account to meet a margin deficiency in the portfolio margin account. In addition, securities, including money market funds, that are not eligible for portfolio margin treatment would be allowed to be carried in a portfolio margin account for their collateral value, subject to the margin requirement applicable in a regular securities margin account.

### **Day Trading**

The day trading restrictions in Rule 2520 would not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided that a member has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity would otherwise be subject to the day trading restrictions. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions would not apply. A “hedge strategy” for purposes of the rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Members would be expected to monitor portfolio accounts to detect and prevent circumvention of the day trading requirements.

### **Net Capital Treatment**

The proposed rule change would provide that the aggregate portfolio margin and maintenance requirements may not exceed ten times the member's Net Capital, as computed under SEC Rule 15c3-1. This requirement places a ceiling on the amount of portfolio margin a broker-dealer can extend to its customers.

### **Disclosure Document**

NASD Rule 2860(b)(11) prescribes requirements for the delivery of options disclosure documents concerning the opening of customer accounts. Under the proposed rule change, members would be required to provide every portfolio margin customer with a written risk disclosure statement at or prior to the initial transaction in a portfolio margin account. The disclosure would be in a format prescribed by NASD or in a format developed by the member, provided it contains substantially similar information as in the prescribed NASD format and has received the prior written approval of NASD. NASD will issue a Notice to Members to set forth the language required in the written disclosure statement.

NASD has filed the proposed rule change for immediate effectiveness. As noted above, the proposed rule change would establish a pilot program that would begin on April 2, 2007 and end on July 31, 2007 to conform to the time periods of the similar portfolio margin pilot programs of the NYSE and CBOE.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>14</sup> which requires, among other things, that NASD rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change will better align the margin requirements with actual risk.

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

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

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

Written comments were neither solicited nor received.

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

Because the foregoing proposed rule change does not:

- (i) significantly affect the protection of investors or the public interest;
- (ii) impose any significant burden on competition; and
- (iii) become operative for 30 days from the date on which it was filed, or such

shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder.<sup>15</sup>

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<sup>14</sup> 15 U.S.C. 78o-3(b)(6).

<sup>15</sup> 17 CFR 240.19b-4(f)(6).

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### **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. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2007-013 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2007-013. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2007-013 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

Nancy M. Morris

Secretary

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<sup>16</sup> 17 CFR 200.30-3(a)(12).

**EXHIBIT 5**

Amendments to Rule 2520 (Margin Requirements) and Rule 2860 (Options).

Proposed new rule language is underlined.

\* \* \* \* \*

**2520. Margin Requirements**

(a) through (f) No Change.

**(g) Portfolio Margin**

As an alternative to the “strategy-based” margin requirements set forth in paragraphs (a) through (f) of this Rule, members may elect to apply the portfolio margin requirements set forth in this paragraph (g) to all margin equity securities,<sup>1</sup> listed options, security futures products (as defined in Section 3(a)(56) of the Exchange Act), unlisted derivatives, warrants, index warrants and related instruments, provided that the requirements of paragraph (g)(6)(B)(i) of this Rule are met.

In addition, a member, provided that it is a Futures Commission Merchant (“FCM”) and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this paragraph (g) to combine an eligible participant’s related instruments as defined in paragraph (g)(2)(D), with listed index options, unlisted derivatives, options on exchange traded funds (“ETF”), index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis.

The portfolio margin provisions of this Rule shall not apply to Individual Retirement Accounts (“IRAs”).

(1) **Monitoring.** — Members must monitor the risk of portfolio margin accounts and maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member’s capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology must be filed with NASD, or the member’s designated examining authority (“DEA”) if other than NASD, and submitted to the Commission prior to the implementation of portfolio margining. In performing the risk analysis of portfolio margin accounts required by this Rule, each member shall include in the written risk analysis methodology procedures and guidelines for:

(A) obtaining and reviewing the appropriate account documentation and financial information necessary for assessing the amount of credit to be extended to eligible participants;

(B) the determination, review and approval of credit limits to each eligible participant, and across all eligible participants, utilizing a portfolio margin account;

(C) monitoring credit risk exposure to the member from portfolio margin accounts, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management;

(D) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate;

(E) the regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group;

(F) managing the impact of credit extended related to portfolio margin accounts on the member's overall risk exposure;

(G) the appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded; and

(H) determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product.

Moreover, management must periodically review, in accordance with written procedures, the member's credit extension activities for consistency with these guidelines. Management must periodically determine if the data

necessary to apply this paragraph (g) is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

**(2) Definitions.** — For purposes of this paragraph (g), the following terms shall have the meanings specified below:

(A) The term “listed option” means any equity-based or equity index-based option traded on a registered national securities exchange or automated facility of a registered national securities association.

(B) The term “portfolio” means any eligible product, as defined in paragraph (g)(6)(B)(i), grouped with its underlying instruments and related instruments.

(C) The term “product group” means two or more portfolios of the same type (see table in paragraph (g)(2)(F)below) for which it has been determined by SEC Rule 15c3-1a that a percentage of offsetting profits may be applied to losses at the same valuation point.

(D) The term “related instrument” within a security class or product group means broad-based index futures and options on broad-based index futures covering the same underlying instrument. The term “related instrument” does not include security futures products.

(E) The term “security class” refers to all listed options, security futures products, unlisted derivatives, and related instruments

covering the same underlying instrument and the underlying instrument itself.

(F) The term “theoretical gains and losses” means the gain and loss in the value of individual eligible products and related instruments at ten equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument. The magnitude of the valuation point range shall be as follows:

| <u>Portfolio Type</u>   | <u>Up / Down Market Move (High &amp; Low Valuation Points)</u> |
|---|--|
| <u>High Capitalization, Broad-based Market Index<sup>2</sup></u>                                      | <u>+6% / -8%</u>   |
| <u>Non-High Capitalization, Broad-based Market Index<sup>3</sup></u>                                  | <u>+/- 10%</u>   |
| <u>Any other eligible product that is, or is based on, an equity security or a narrow-based index</u> | <u>+/- 15%</u>   |

(G) The term “underlying instrument” means a security or security index upon which any listed option, unlisted derivative, security future, or broad-based index future is based.

(H) The term “unlisted derivative” means any equity-based or equity index-based unlisted option, forward contract, or security-based

swap that can be valued by a theoretical pricing model approved by the Commission.

**(3) Approved Theoretical Pricing Models.** — Theoretical pricing models must be approved by the Commission.

**(4) Eligible Participants.** — The application of the portfolio margin provisions of this paragraph (g) is limited to the following:

(A) any broker or dealer registered pursuant to Section 15 of the Exchange Act;

(B) any member of a national futures exchange to the extent that listed index options, unlisted derivatives, options on ETFs, index warrants or underlying instruments hedge the member's index futures;  
and

(C) any person or entity not included in paragraphs (g)(4)(A) and (g)(4)(B) above approved for uncovered options and, if transactions in security futures are to be included in the account, approval for such transactions is also required. However, an eligible participant under this paragraph (g)(4)(C) may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member. For purposes of this minimum equity requirement, all securities and futures accounts carried by the member for the same eligible participant may be combined provided ownership across the

accounts is identical. A guarantee pursuant to paragraph (f)(4) of this Rule is not permitted for purposes of the minimum equity requirement.

**(5) Opening of Accounts**

(A) Members must notify and receive approval from NASD, or the member's DEA if other than NASD, prior to establishing a portfolio margin methodology for eligible participants.

(B) Only eligible participants that have been approved to engage in uncovered short option contracts pursuant to NASD Rule 2860, or the rules of the member's DEA if other than NASD, are permitted to utilize a portfolio margin account.

(C) On or before the date of the initial transaction in a portfolio margin account, a member shall:

(i) furnish the eligible participant with a special written disclosure statement describing the nature and risks of portfolio margining which includes an acknowledgement for all portfolio margin account owners to sign, attesting that they have read and understood the disclosure statement, and agree to the terms under which a portfolio margin account is provided (see NASD Rule 2860(c)); and

(ii) obtain the signed acknowledgement noted above from the eligible participant and record the date of receipt.

**(6) Establishing Account and Eligible Positions**

(A) For purposes of applying the portfolio margin requirements prescribed in this paragraph (g), members are to establish and utilize a specific securities margin account, or sub-account of a margin account, clearly identified as a portfolio margin account that is separate from any other securities account carried for an eligible participant.

A margin deficit in the portfolio margin account of an eligible participant may not be considered as satisfied by excess equity in another account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained.

However, if a portfolio margin account is carried as a sub-account of a margin account, excess equity in the margin account (determined in accordance with the rules applicable to a margin account other than a portfolio margin account) may be used to satisfy a margin deficit in the portfolio margin sub-account without having to transfer any funds and/or securities.

**(B) Eligible Products**

(i) For eligible participants as described in paragraphs (g)(4)(A) through (g)(4)(C), a transaction in, or transfer of, an eligible product may be effected in the portfolio margin account. Eligible products under this paragraph (g) consist of:

(a) a margin equity security (including a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a “ready market” under SEC Rule 15c3-1 or a “no-action” position issued thereunder, and a control or restricted security, provided the security has met the requirements in a manner consistent with SEC Rule 144 or a Commission “no-action” position issued thereunder, sufficient enough to permit the sale of the security, upon exercise or assignment of any listed option or unlisted derivative written or held against it, without restriction);

(b) a listed option on an equity security or index of equity securities;

(c) a security futures product;

(d) an unlisted derivative on an equity security or index of equity securities;

(e) a warrant on an equity security or index of equity securities; and

(d) a related instrument as defined in paragraph (g)(2)(D).

**(7) Margin Required.** — The amount of margin required under this paragraph (g) for each portfolio shall be the greater of:

(A) the amount for any of the ten equidistant valuation points representing the largest theoretical loss as calculated pursuant to paragraph (g)(8) below; or

(B) for eligible participants as described in paragraph (g)(4)(A) through (g)(4)(C), \$.375 for each listed option, unlisted derivative, security future product, and related instrument, multiplied by the contract's or instrument's multiplier, not to exceed the market value in the case of long contracts in eligible products.

(C) Account guarantees pursuant to paragraph (f)(4) of this Rule are not permitted for purposes of meeting margin requirements.

(D) Positions other than those listed in Paragraph (g)(6)(B)(i) above are not eligible for portfolio margin treatment. However, positions not eligible for portfolio margin treatment (except for ineligible related instruments) may be carried in a portfolio margin account, provided the member has the ability to apply the applicable strategy-based margin requirements promulgated under this Rule. Shares of a money market mutual fund may be carried in a portfolio margin account, also subject to the applicable strategy-based margin requirement under this Rule provided that:

(i) the customer waives any right to redeem shares without the member's consent;

(ii) the member (or, if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem shares in cash upon request;

(iii) the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request; and

(iv) the member complies with the requirements of Section 11(d)(1) of the Exchange Act and SEC Rule 11d1-2 thereunder.

**(8) Method of Calculation**

(A) Long and short positions in eligible products, including underlying instruments and related instruments, are to be grouped by security class; each security class group being a "portfolio." Each portfolio is categorized as one of the portfolio types specified in paragraph (g)(2)(F) above, as applicable.

(B) For each portfolio, theoretical gains and losses are calculated for each position as specified in paragraph (g)(2)(F) above. For purposes of determining the theoretical gains and losses at each valuation point, members shall obtain and utilize the theoretical values

of eligible products as described in this paragraph (g) rendered by an approved theoretical pricing model.

(C) Offsets. Within each portfolio, theoretical gains and losses may be netted fully at each valuation point. Offsets between portfolios within the eligible product groups, as described in paragraph (g)(2)(F), may then be applied as permitted by SEC Rule 15c3-1a.

(D) After applying the offsets above, the sum of the greatest loss from each portfolio is computed to arrive at the total margin required for the account (subject to the per contract minimum).

(E) In addition, if a security that is convertible, exchangeable, or exercisable into a security that is an underlying instrument requires the payment of money or would result in a loss if converted, exchanged, or exercised at the time when the security is deemed an underlying instrument, the full amount of the conversion loss is required.

**(9) Portfolio Margin Minimum Equity Deficiency**

(A) If, as of the close of business, the equity in the portfolio margin account of an eligible participant as described in paragraph (g)(4)(C), declines below the five million dollar minimum equity required, if applicable, and is not restored to at least five million dollars within three business days by a deposit of funds and/or securities or through favorable market action, members are prohibited

from accepting new opening orders beginning on the fourth business day, except that new opening orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until,

(i) equity of five million dollars is established, or

(ii) all unlisted derivatives are liquidated or transferred from the portfolio margin account to the appropriate securities account.

(B) Members will not be permitted to deduct any portfolio margin minimum equity deficiency amount from Net Capital in lieu of collecting the minimum equity required.

**(10) Portfolio Margin Deficiency**

(A) If, as of the close of business, the equity in the portfolio margin account of an eligible participant, as described in paragraph (g)(4)(A) through (g)(4)(C), is less than the margin required, the eligible participant may deposit additional funds and/or securities or establish a hedge to meet the margin requirement within three business days. After the three business day period, members are prohibited from accepting new opening orders, except that new opening orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. In the event an eligible participant fails to hedge existing positions or deposit additional funds

and/or securities in an amount sufficient to eliminate any margin deficiency after three business days, the member must liquidate positions in an amount sufficient to, at a minimum, lower the total margin required to an amount less than or equal to the account equity.

(B) If the portfolio margin deficiency is not met by the close of business on the next business day after the business day on which such deficiency arises, members will be required to deduct the amount of the deficiency from Net Capital until such time the deficiency is satisfied or positions are liquidated pursuant to paragraph (g)(10)(A) above.

(C) Members will not be permitted to deduct any portfolio margin deficiency amount from Net Capital in lieu of collecting the margin required.

(D) NASD, or the member's DEA if other than NASD, may grant additional time for an eligible participant to meet a portfolio margin deficiency upon written request, which is expected to be granted in extraordinary circumstances only.

(E) Notwithstanding the provisions of subparagraph (B) above, members should not permit an eligible participant to make a practice of meeting a portfolio margin deficiency by liquidation. Members must have procedures in place to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and

the member is expected to take appropriate action when warranted.

Liquidation to eliminate margin deficiencies that are caused solely by adverse price movements may be disregarded.

**(11) Determination of Value for Margin Purposes.** — For the purposes of this paragraph (g), all eligible products shall be valued at current market prices. Account equity for the purposes of paragraphs (g)(9)(A) and (g)(10)(A) shall be calculated separately for each portfolio margin account by adding the current market value of all long positions, subtracting current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.

**(12) Net Capital Treatment of Portfolio Margin Accounts**

(A) No member that requires margin in any portfolio account pursuant to paragraph (g) of this Rule shall permit the aggregate portfolio margin requirements to exceed ten times its Net Capital for any period exceeding three business days. The member shall, beginning on the fourth business day, cease opening new portfolio margin accounts until compliance is achieved.

(B) If, at any time, a member's aggregate portfolio margin requirements exceed ten times its Net Capital, the member shall immediately transmit telegraphic or facsimile notice of such deficiency to the principal office of the Commission in Washington, D.C., the district or regional office of the Commission for the district or region

in which the member maintains its principal place of business; and to NASD, or the member's DEA if other than NASD. Notice to NASD shall be in such form as NASD may prescribe.

**(13) Day Trading Requirements.** —The day trading restrictions promulgated under paragraph (f)(8)(B) of this Rule shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided that a member has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under paragraph (f)(8)(B) of this Rule, provided the member has the ability to apply the applicable day trading requirement under this Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A “hedge strategy” for purposes of this Rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Members are expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements.

**(14) Requirements to Liquidate**

(A) A member is required immediately either to liquidate, or transfer to another broker-dealer eligible to carry portfolio margin accounts, all portfolio margin accounts with positions in related instruments if the member is:

(i) insolvent as defined in section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature;

(ii) the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such debtor has been appointed;

(iii) not in compliance with applicable requirements under the Exchange Act or rules of the Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of eligible participant's securities; or

(iv) unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

(B) Nothing in this paragraph (g)(14) shall be construed as limiting or restricting in any way the exercise of any right of a registered clearing agency to liquidate or cause the liquidation of positions in accordance with its by-laws and rules.

(15) Members must ensure that portfolio accounts are in compliance with Rule 2860.

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<sup>1</sup> For purposes of this paragraph (g) of the Rule, the term “margin equity security” utilizes the definition at Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.

<sup>2</sup> In accordance with paragraph (b)(1)(i)(B) of SEC Rule 15c3-1a (Appendix A to SEC Rule 15c3-1), 17 CFR 240.15c3-1a(b)(1)(i)(B).

<sup>3</sup> See footnote 2.

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## **2860. Options**

(a) through (b) No Change.

### **(c) Portfolio Margining Disclosure Statement and Acknowledgement**

The special written disclosure statement describing the nature and risks of portfolio margining, and acknowledgement for an eligible participant signature, required by Rule 2520(g)(5)(C) shall be in a format prescribed by NASD or in a format developed by the member, provided it contains substantially similar information as in the prescribed NASD format and has received the prior written approval of NASD.