INFORMATIONAL

SEC Approves Proposed Rule Change

Relating To Cash And Margin Treatment For Certain Types Of Options Positions

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Operations
- Options

KEY TOPICS

- Rule 2520
- Rule 2522
- Margin
- Options

Executive Summary

On November 17, 2000, the Securities and Exchange Commission (SEC or Commission) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rules 2520 and 2522, relating to margin requirements for certain options positions (the "amendments").[1] The amendments become effective on **February 26, 2001** and are substantially similar to amendments by the Chicago Board Options Exchange (CBOE) and the New York Stock Exchange (NYSE) to their margin rules.[2]

The text of the amendments and *Federal Register* version of the SEC Approval Order are attached. For a complete description of the amendments, as well as specific examples of certain margin calculations under the amendments, members should review the attached SEC Approval Order.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan DeMando, Director, Financial Operations, Member Regulation, NASD Regulation, Inc. (NASD Regulation℠), at (202) 728-8411, or Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background And Discussion

Until several years ago, the margin requirements governing listed options[3] were set forth in Regulation T. However, Federal Reserve Board amendments to Regulation T that became effective on June 1, 1997, modified or deleted certain margin requirements regarding options transactions in favor of rules to be adopted by the self-regulatory organizations (SROs), subject to approval by the Commission.[4] In response, NASD Regulation is amending NASD Rules 2520 and 2522 to:

- expand the types of short options positions that would be considered "covered" and eligible for the cash account to include short positions that are components of certain limited risk spread strategies (box spreads, butterfly spreads, and debit and credit spreads), provided that any potential risk to the carrying broker/dealer is paid for in full and retained in the account;
- reduce the required margin for butterfly and box spreads by recognizing butterfly and box spreads as strategies (rather than separate transactions) for purposes of margin treatment;
- permit the extension of credit on certain long box spreads;
- recognize various hedging strategies involving stocks (or other underlying instruments) paired with long options, and reduce the required maintenance margin on such hedged stock positions;
- permit the extension of credit on certain long-term options and warrants with over nine months until expiration;
- revise the minimum margin requirement for short uncovered put options; and
- define specific terms relating to the amendments including "box spread," "butterfly spread," and "escrow agreement."

Butterfly Spreads, Box Spreads, And Other Spreads

The amendments permit butterfly and box spreads in cash-settled, European-style[5] options to be eligible for the cash account. The amendments also reduce the required margin for butterfly and box spreads by recognizing butterfly and box spreads as strategies (rather than separate transactions) for purposes of margin treatment. In addition, the amendments permit the extension of credit on certain long box spreads.

The amendments define the terms "butterfly spread" and "box spread" options strategies, specifying what multiple option positions, if held together, qualify for classification as butterfly or box spreads, and consequently are eligible for cash and margin treatments. In addition, the amendments define "escrow agreement," as used in connection with cash-settled calls, puts, currency warrants, currency index warrants, or stock index warrants carried short and as used in connection with non-cash settled put or call options carried short.

Cash Account Treatment: To qualify for carrying in the cash account, the butterfly spreads and box spreads must meet the specifications contained in the definitions of those terms and be comprised of options that (1) are listed or guaranteed by the carrying broker/dealer; (2) have European-style exercise; and (3) are held in, or purchased for, the account on the same day.

For long butterfly spreads and long box spreads, full payment of the net debit that is incurred when the spread strategy is established is required at the time the strategy is established or must be deposited promptly thereafter.

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 could accrue to the account. To eliminate the risk to the broker/dealer carrying the short butterfly spread, the amendments require that an amount equal to the maximum risk be held or deposited in the account in the form of cash or cash equivalents. The maximum potential risk in a short butterfly spread comprised of call options is the aggregate difference between the two lowest exercise prices. With respect to short butterfly spreads comprised of put options, the maximum potential risk is the aggregate difference between the two highest exercise prices. The net credit received from the sale of the short option components can be applied towards the requirement.

Short box spreads also generate a credit balance when established. This credit is nearly equal to the total debit (loss) that will accrue to the account if held to expiration. The amendments 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. The net credit received from the sale of the short option components may be applied towards the requirement.

In addition to butterfly spreads and box spreads, the amendments 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.[6] The long and short positions making up the spread must expire concurrently, and the long position must be paid in full.

Margin Account Treatment: Under current margin rules, butterfly and box spreads are not recognized for margin purposes. The underlying components that make up the spreads must be margined separately. The amendments, however, permit the spreads to be viewed in combination, and therefore, commensurate with the lower combined risk, investors can receive the benefit of lower margin requirements.

To be recognized as a distinct strategy in a margin account, the butterfly spreads and box spreads must meet the specifications contained in the definitions of those terms and the options positions must be listed or guaranteed by the carrying broker/dealer. As required for cash account treatment of long butterfly spreads, 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.

With respect to long box spreads, where the component options are not European-style, the amendments require full payment of the net debit that is incurred when the spread strategy is established. For short box spreads held in the margin account, the amendments 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 do not have loan value for margin equity purposes. However, the amendments permit the extension of credit on long box spreads composed entirely of European-style options that are listed or guaranteed by the carrying broker/dealer. For long box spreads made up of European-style options, the amendments require initial and maintenance margin of 50 percent of the aggregate difference in the two exercise prices (buy and sell), which results in a margin requirement slightly higher than 50 percent of the debit typically incurred in establishing such a position. A long box spread position is allowed market value for margin equity purposes of not more than 100 percent of the aggregate difference in the exercise prices of the options.

Extension Of Credit On Long-Term Options And Warrants

The amendments permit extensions of credit on certain long listed and over-the-counter (OTC)[7] options and warrant products (*i.e.*, stock index warrants, but not traditional stock warrants issued by a corporation on its own stock). Only those options or warrants with expirations exceeding nine months ("long-term") are eligible for credit extension.[8] The amendments, however, do not provide loan value for foreign currency options.

The amendments require initial and maintenance margin of not less than 75 percent of the current market value of long-term listed options and warrants. Therefore, members will be permitted to loan up to 25 percent of the current market value of a long-term listed option or warrant. For example, if an investor purchased a listed call option on stock XYZ that expired in January 2001 for approximately $100 (excluding commissions), the investor would be required to deposit and maintain at least $75. The investor could borrow the remaining $25 from the member. Under the current margin rules, the investor would be required to pay the entire $100.

The amendments also permit the extension of credit on certain long-term OTC options and warrants. Specifically, a member can extend credit on an OTC put or call option on a stock or stock index, and on an OTC stock index warrant. In addition to being more than nine months from expiration, a marginable OTC option or warrant must: (1) be in-the-money and valued at all times for margin purposes at an amount not to exceed the in-the-money amount; (2) be guaranteed by the carrying broker/dealer; and (3) have an American-style[9] exercise provision. If the marginable OTC options meets these conditions, initial and maintenance margin of 75 percent of the long-term OTC option's or warrant's in-the-money amount (*i.e.*, its intrinsic value) is required.

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 becomes 100 percent of the current market value. Options or warrants expiring in less than nine months do not have loan value under the rule change because of the leverage and volatility of those instruments.

Maintenance Margin Requirements For Stock Positions Held With Options Positions

The amendments recognize and establish reduced maintenance margin requirements for five options strategies that are 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 stock positions held in conjunction with an overlying option (or options), the amendments also apply to components that underlie index options and warrants. For example, these same maintenance margin requirements apply when these strategies are used with a stock basket underlying index options or warrants.

Long Put/Long Stock

The Long Put/Long Stock hedging strategy requires an investor to carry in an account a long position in the component underlying the put option, and a long put option specifying equivalent units of the underlying component. This strategy is designed to limit downside risk in the underlying stock while the put is held. The put holder retains the right to sell stock at the strike price through the expiration of the put. The maintenance margin requirement for the Long Put/Long Stock combination would be the lesser of: (a) 10 percent of the put option aggregate exercise price, plus 100 percent of any amount by which the put option is out-of-the-money; or (b) 25 percent of the current market value of the long stock position.

Long Call/Short Stock

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

Conversion (Long Stock/Long Put/Short Call)

A "Conversion" is a long stock position in conjunction with a long put and a short call. For a Conversion to qualify as hedged, the long put and the short call must have the same expiration and exercise price. The short call is covered by the long stock, and the long put is a right to sell the stock at a predetermined price—the exercise price of the long put. Thus, regardless of any decline in market value, the stock position, in effect, is worth no less than the exercise price of the put.

Current NASD margin rules specify that no maintenance margin would be required on the short call option because it is covered, but the underlying long stock position would be margined according to the current maintenance margin requirement (*i.e.*, 25 percent of the current market value). Under the amendments, the maintenance margin requirement for a Conversion would be 10 percent of the aggregate exercise price.

Reverse Conversion (Short Stock/Short Put/Long Call)

A "Reverse Conversion" is a short stock position held in conjunction with a short put and a long call. As with the Conversion, the short put and long call must have the same expiration date and exercise price. Regardless of any rise in market value, the stock can be acquired for the call exercise price; in effect, the short position is valued at no more than the call exercise price. Under the amendments, the maintenance margin requirement for a Reverse Conversion would be 10 percent of the aggregate exercise price, plus any in-the-money amount (*i.e.*, the amount by which the exercise price of the short put exceeds the current market value of the underlying stock position).

Collar (Long Stock/Long Put/Short Call)

A "Collar" is a long stock position held in conjunction with a long put and a short call. In a Collar, as compared to a Conversion, the exercise price of the long put is lower than the exercise price of the short call. Therefore, the options positions in a Collar do not constitute a pure synthetic short stock position. The maintenance margin for a Collar under the amendments would be the lesser of: (a) 10 percent of the long put aggregate exercise price, plus 100 percent of any amount by which the long put is out-of-the-money; or (b) 25 percent of the short call aggregate exercise price.

Margin Requirements For Short Put Options

Currently, 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. As a result, a margin requirement for a short put option is created 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. Therefore, the amendments provide a minimum margin requirement for short put options more in line with the risk associated with the option. Specifically, under the amendments, 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.

Endnotes

1 *See* Securities Exchange Act Release No. 43581 (November 17, 2000), 65 FR 70854 (November 28, 2000) (File No. SR-NASD-00-15) ("SEC Approval Order").

2 *See* Securities Exchange Act Release Nos. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving File No. SR-CBOE-97-67); and 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving File No. SR-NYSE-99-03).

3 Listed options are issued by The Options Clearing Corporation (OCC), a clearing agency registered pursuant to Section 17A of the Securities Exchange Act of 1934.

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

5 A European-style option may be exercised only at its expiration pursuant to the rules of the OCC.

6 A long warrant may offset a short option contract and a long option contract may offset a short warrant provided they have the same underlying component or index and equivalent aggregate current underlying value. If the long position is not listed, it must be guaranteed by the carrying broker-dealer; otherwise, the short position is not eligible for the cash account and must be margined separately pursuant to NASD Rule 2520(f)(2)(D).

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

8 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 percent of the purchase price of the option or warrant.

9 An American-style option is exercisable on any business day prior to its expiration date and on its expiration date.

ATTACHMENT A

Rule Language – SR-NASD-00-15

(Note: New language is underlined; and deletions are bracketed)

2520. Margin Requirements

a) through (e) No Change

(f) Other Provisions

(1) Determination of Value for Margin Purposes

Active securities dealt in on a national securities exchange or OTC Marginable securities listed on Nasdaq shall, for margin purposes, be valued at current market prices; provided that, whether or not dealt in on an exchange or listed on Nasdaq, only those options contracts on a stock or stock index, or a stock index warrant, having an expiration that exceeds nine months and that are listed or guaranteed by the carrying broker-dealer, may be deemed to have market value for the purposes of Rule 2520. Other securities shall be valued conservatively in view of current market prices and the amount which might be realized upon liquidation. Substantial additional margin must be required in all cases where the securities carried in "long" or "short" positions are subject to unusually rapid or violent changes in value, or do not have an active market on Nasdaq or on a national securities exchange, or where the amount carried is such that the position(s) cannot be liquidated promptly.

(2) Puts, Calls, Other Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants

(A) Except as provided below, and in the case of a put, call index stock group option, or stock index warrant with a remaining period to expiration exceeding nine months, no put, call, currency warrant, currency index warrant or stock index warrant carried for a customer shall be considered of any value for the purpose of computing the margin to be maintained in the account of such customer.

(B) No Change

(C) For purposes of this subparagraph [(6)(B)] (f)(2), obligations issued by the United States Government shall be referred to as United States Government obligations. Mortgage pass-through obligations guaranteed as to timely payment of principal and interest by the Government National Mortgage Association shall be referred to as GNMA obligations. [The terms "current market value" or "current market price" of an options, currency warrant, currency index warrant or stock index warrant shall mean the total cost or net proceeds of the option contract or warrant on the day it was purchased or sold and at any other time shall be the preceding business day's closing price of that option (times the appropriate unit of trading or multiplier) as shown by any regularly published reporting or quotation service. The term "exercise settlement amount" shall mean the difference between the "aggregate exercise price" and the "aggregate current index value" (as such terms are defined in the pertinent By-Laws of the Options Clearing Corporation).]

In the case of any put, call, currency warrant, currency index warrant, or stock index warrant carried "long" in a customer's account that expires in nine months or less, initial margin must be deposited and maintained equal to at least 100% of the purchase price of the option or warrant.

Long Listed Option or Warrant With An Expiration Exceeding Nine Months. In the case of a put, call, index stock group option, or stock index warrant that is issued by a registered clearing agency, margin must be deposited and maintained equal to at least 75% of the current market value of the option or warrant; provided that the option or warrant has a remaining period to expiration exceeding nine months.

Long OTC Option or Warrant With An Expiration Exceeding Nine Months. In the case of an OTC put or call option on a stock or stock index, and a stock index warrant, with an expiration exceeding 9 months, margin must be deposited and maintained equal to at least 75% of the option's or warrant's in-the-money amount. Options or warrants margined pursuant to this paragraph must:

(i) be valued at all times for margin purposes at an amount not to exceed, the in-the-money amount,
(ii) be guaranteed by the carrying broker-dealer, and
(iii) have an American-style exercise provision.

(D) The margin required on any put [or call issued], call, currency warrant, currency index warrant, or stock index warrant issued, guaranteed or carried "short" in a customer's account shall be:

(i) In the case of puts and calls issued by a registered clearing agency, 100 percent of the current market value of the option plus the percentage of the current value of the underlying [security or index] component specified in column II of the chart below. In the case of currency warrants, currency index warrants and stock index warrants, 100 percent of the current market value of each such warrant plus the percentage of the warrant's current "underlying component value" (as column IV of the chart below describes) specified in column II of the chart below.

[Notwithstanding the margin required below, t]The [minimum] margin on any put[or call issued], call, currency warrant, currency index warrant, or stock index warrant issued, guaranteed or carried "short" in a customer's account may be reduced by any "out-of-the-money amount" (as defined below), but shall not be less than 100 percent of the current market value of the option or warrant plus the percentage of the current value of the underlying [security or index] component specified in column III, except in the case of any put issued, guaranteed or carried "short" in a customer's account. Margin on such put option contracts shall not be less than the current value of the put option plus the percentage of the put option's aggregate exercise price as specified in column III.

* * * No Change to Tables * * *

If the option contract provides for the delivery of obligations with different maturity dates or coupon rates, the computation of the "out-of-the-money amount," if any, where required by this Rule, shall be made in such a manner as to result in the highest margin requirement on the short option position.

(ii) In the case of puts and calls issued by a registered clearing agency which represent options on GNMA obligations in the principal amount of $100,000, 130 percent of the current market value of the option plus $1,500, except that the margin required need not exceed $5,000 plus the current market value of the option.

(iii) In the case of puts and calls not issued by a registered clearing agency, the percentage of the current value of the underlying component and the applicable multiplier, if any, specified in column II below, plus any "in-the-money amount" (as defined in this paragraph (f)(2)(D)(iii).)

[Notwithstanding the margin required by this subparagraph] In the case of options not issued by a registered clearing agency, the [minimum] margin on any put or call issued, guaranteed or carried "short" in a customer's account may be reduced by any "out of the money amount" (as defined in paragraph (f)(2)(D)(i)), but shall not be less than the percentage of the current value of the underlying component and the applicable multiplier, if any, specified in column III below, except in the case of any put issued or guaranteed or carried "short" in a customer's account. Margin on such put option contracts shall not be less than the percentage of the put option's exercise price as specified in column III below.

* * * No Change to Tables * * *

(D)(iv) through (G)(iv) No Change.

(G)(v) The following requirements set forth the minimum amount of margin that must be maintained in margin accounts of customers having positions in components underlying options, and stock index warrants, when such components are held in conjunction with certain positions in the overlying option or warrant. The option or warrant must be issued by a registered clearing agency or guaranteed by the carrying broker/dealer. In the case of a call or warrant carried in a short position, a related long position in the underlying component shall be valued at no more than the call/warrant exercise price for margin equity purposes.

a. Long Option or Warrant Offset. When a component underlying an option or warrant is carried long (short) in an account in which there is also carried a long put (call) or warrant specifying equivalent units of the underlying component, the minimum amount of margin that must be maintained on the underlying component is 10% of the aggregate option/warrant exercise price plus the "out-of-the-money" amount, not to exceed the minimum maintenance required pursuant to paragraph (c) of this Rule.

b. Conversions. When a call or warrant carried in a short position is covered by a long position in equivalent units of the underlying component and there is also carried with a long put or warrant specifying equivalent units of the same underlying component and having the same exercise price and expiration date as the short call or warrant, the minimum amount of margin that must be maintained for the underlying component shall be 10% of the aggregate exercise price.

c. Reverse Conversions. When a put or warrant carried in a short position is covered by a short position in equivalent units of the underlying component and is also carried with a long call or warrant specifying equivalent units of the same underlying component and having the same exercise price and expiration date as the short put or warrant, the minimum amount of margin that must be maintained for the underlying component shall be 10% of the aggregate exercise price plus the amount by which the exercise price of the put exceeds the current market value of the underlying, if any.

d. Collars. When a call or warrant carried in a short position is covered by a long position in equivalent units of the underlying component and is also carried with a long put or warrant specifying equivalent units of the same underlying component and having a lower exercise price and the same expiration date as the short call/warrant, the minimum amount of margin that must be maintained for the underlying component shall be the lesser of 10% of the aggregate exercise price of the put plus the put "out-of-the-money" amount or 25% of the call aggregate exercise price.

e. Butterfly Spread. This subparagraph applies to a butterfly spread as defined in Rule 2522 where all option positions are issued by a registered clearing agency or guaranteed by the carrying broker/dealer.

1. With respect to a long butterfly spread as defined in Rule 2522, the net debit must be paid in full.

2. With respect to a short butterfly spread as defined in Rule 2522, margin must be deposited and maintained equal to at least the amount of the aggregate difference between the two lowest exercise prices with respect to short butterfly spreads comprised of calls or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of puts. The net proceeds from the sale of short option components may be applied to the requirement.

f. Box Spread. This subparagraph applies to box spreads as defined in Rule 2522, where all option positions are issued by a registered clearing agency or guaranteed by the carrying broker/dealer.

1. With respect to a long box spread as defined in Rule 2522 the net debit must be paid in full.

2. With respect to a short box spread as defined in Rule 2522, margin must be deposited and maintained equal to at least the amount of the aggregate difference between the exercise prices. The net proceeds from the sale of the short option components may be applied to the requirement.

g. Long Box Spread in European-Style Options. With respect to a long box spread as defined in Rule 2522, in which all component options have a European-style exercise provision and are issued by a registered clearing agency or guaranteed by the carrying broker/dealer, margin must be deposited and maintained equal to a least 50% of the aggregate difference in the exercise prices. The net proceeds from the sale of short option components may be applied to the requirement. For margin purposes, the long box spread may be valued at an amount not to exceed 100% of the aggregate difference in the exercise prices.

(f)(2)(H) through (f)(2)(L) No Change

(M) Cash account transactions. - A member may make option transactions in a customer's cash account, provided that:

(i) The transaction is permissible under Regulation T, Section 220.8; or

(ii) [The transaction is a debit put spread in listed broad-based index options with European-style exercise comprised of a long put(s) coupled with a short put(s) overlying the same broad-based index with an equivalent underlying aggregate index value and the short put(s) and the long put(s) expire simultaneously, and the strike price of the long put(s) exceed the strike price of the short put(s).] **Spreads.** A European-style cash-settled index stock group option or stock index warrant carried in a short position is deemed a covered position, and eligible for the cash account, provided a long position in a European-style cash-settled stock group index option, or stock index warrant having the same underlying component or index that is based on the same aggregate current underlying value, is held in or purchased for the account on the same day, provided that:

a. the long position and the short position expire concurrently;

b. the long position is paid is full; and

c. there is held in the account at the time the positions are established, or received into the account promptly thereafter:

1. cash or cash equivalents of not less than any amount by which the aggregate exercise price of the long call or call warrant (short put or put warrant) exceeds the aggregate exercise price of the short call or call warrant (long put or put warrant), to which requirement of net proceeds from the sale of the short position may be applied, or

2. an escrow agreement.

The escrow agreement must certify that the bank holds for the account of the customer as security for the agreement i. cash, ii. cash equivalents, or iii. a combination thereof having an aggregate market value at the time the positions are established of not less than any amount by which the aggregate exercise price of the long call or call warrant (short put or put warrant) exceeds the aggregate exercise price of a short call or call warrant (long put or put warrant) and that the bank will promptly pay the member such amount in the event the account is assigned an exercise notice or that the bank will promptly pay the member funds sufficient to purchase a warrant sold short in the event of a buy-in.

d. A long warrant may offset a short option contract and a long option contract may offset a short warrant provided that they have the same underlying component or index and equivalent aggregate current underlying value. In the event that the long position is not listed, it must be guaranteed by the carrying broker/dealer; otherwise the short position is not eligible for the cash account and must be margined separately pursuant to subparagraph (f)(2)(D).

(iii) **Butterfly Spreads.** Put or call options carried in a short position are deemed covered positions and eligible for the cash account provided that the account contains long positions of the same type which in conjunction with the short options, constitute a butterfly spread as defined in Rule 2522 and provided that:

a. all component options are listed, or guaranteed by the carrying broker/dealer;

b. all component options are European-style;

c. all component options are cash settled;

d. the long options are held in, or purchased for the account on the same day;

e. with respect to a long butterfly spread as defined in Rule 2522, the net debit is paid in full; and

f. with respect to a short butterfly spread as defined in Rule 2522, there is held in the account at the time the positions are established or received into the account promptly thereafter:

1. cash or cash equivalents 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 or put options, to which requirement the net proceeds from the sale of short option components may be applied; or

2. an escrow agreement.

The escrow agreement must certify that the bank holds for the account of the customer as security for the agreement i. cash, ii. cash equivalents or iii. 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 calls or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of puts and that the bank will promptly pay the member such amount in the event the account is assigned an exercise notice on the call (put) with the lowest (highest) exercise price.

(iv) **Box Spreads.** Puts and calls carried in a short position are deemed covered positions and eligible for the cash account provided that the account contains long positions which in conjunction with the short options constitute a box spread as defined in Rule 2522 provided that:

a. all component options are listed, or guaranteed by the carrying broker/dealer;

b. all component options are European-style;

c. all component options are cash settled;

d. the long options are held in, or purchased for the account on the same day;

e. with respect to a long box spread as defined in Rule 2522, the net debit is paid in full; and

f. with respect to a short box spread as defined in Rule 2522, there is held in the account at the time the positions are established, or received into the account promptly thereafter:

1. cash or cash equivalents of not less than the amount of the aggregate difference between the exercise prices, to which requirement the net proceeds from the sale of short option components may be applied; or

2. an escrow agreement.

The escrow agreement must certify that the bank holds for the account of the customer as security for the agreement i. cash, ii. cash equivalents or iii. a combination thereof having an aggregate market value at the time the positions are established of not less than the amount of the aggregate difference between the exercise prices and that the bank will promptly pay the member such amount in the event the account is assigned an exercise notice on either short option.

* * *

2522. Definitions Related to Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants Transactions

[(a) Definitions Related to Options Transactions]

(a) The following definitions shall apply to the margin requirements for options, currency warrants, currency index warrants and stock index warrants transactions:

* * *

(6) Box Spread

The term "box spread" means an aggregation of positions in a long call and short put with the same exercise price ("buy side") coupled with a long put and short call with the same exercise price ("sell side") all of which have the same underlying component or index and time of expirations, and are based on the same aggregate current underlying value, and are structured as; (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.

Paragraphs (6) and (7) are renumbered as Paragraphs (7) and (8).

(9) Butterfly Spread

The term “butterfly spread” means an aggregation of positions in three series of either puts or calls all having the same underlying component or index, and time of expiration, and based on the same aggregate current underlying value, where the interval between the exercise price of each series is equal, which positions are structured as either: (A) a “long butterfly spread” in which two short options in the same series are offset by one long option with a higher exercise price and one long option with a lower exercise price or (B) a “short butterfly spread” in which two long options in the same series offset one short option with a higher exercise price and one short option with a lower exercise price.

Paragraphs (8) through (17) are renumbered as Paragraphs (10) through (19).

(20) Current Market Value or Current Market Price

The terms “current market value” or “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 of the Board of Governors of the Federal Reserve System.

Paragraphs (18) and (19) are renumbered as Paragraphs (21) through (22).

(23) Escrow Agreement

The term “escrow agreement,” when used in connection with cash settled calls, puts, currency warrants, currency index warrants or stock index warrants carried short, means any agreement issued in a form acceptable to the Association under which a bank holding cash, cash equivalents, one or more qualified equity securities or combination thereof in the case of a call option or warrant[s] or cash, cash equivalents or a combination thereof in the case of a put option or warrant is obligated (in the case of an option) to pay the creditor the exercise settlement amount in the event an option is assigned an exercise notice [or (in the case of a warrant) the funds sufficient to purchase a warrant sold short in the event 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.

The term “escrow agreement” when used in connection with non cash settled call or put options carried short, means any agreement issued in a form acceptable to the Association under which a bank holding the underlying security (in the case of a call option) or required cash or cash equivalents or a combination thereof (in the case of a put option) is obligated to deliver to the creditor (in the case of a call option) or accept from the creditor (in the case of a put option) the underlying security against payment of the exercise price in the event of the call or put is assigned an exercise notice.

Paragraphs (20) through (22) are renumbered as Paragraphs (24) through (26).

(27) Exercise Settlement Amount

The term “exercise settlement amount” shall mean the difference between the “aggregate exercise price” and the “aggregate current index value” (as such terms are defined in the pertinent By-Laws of the Options Clearing Corporation).

Paragraphs (23) through (58) are renumbered as Paragraphs (28) through (63).

(64) Stock Index Warrant

The term “stock index warrant” shall mean a put or call warrant that overlies a broad index stock group or an industry index stock group.

Paragraphs (59) through (71) are renumbered as Paragraphs (65) through (77).