Executive Summary

On February 12, 2007, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a rule change to amend Rule 2520 to permit members to margin certain products according to a prescribed portfolio margin methodology on a pilot basis. NASD also amended 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.1

Rules 2520 and 2860, as amended, are set forth in Attachment A of this Notice. The portfolio margin program 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.

Questions/Further Information

Questions regarding this Notice may be directed to Susan M. DeMando, Associate Vice President, Financial Operations, at (202) 728-8411, or Kathryn M. Moore, Assistant General Counsel, Office of General Counsel, at (202) 974-2974.

Background and Discussion

Section 7(a) of the Securities Exchange Act of 1934 (the Exchange Act) 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 margin rules, subject to SEC approval.2

Accordingly, NASD has amended Rule 2520 to allow members on a pilot basis, subject to specified conditions, to elect to apply a portfolio margin methodology to all margin equity securities,3 listed options, security futures products,4 unlisted derivatives,5 warrants, index warrants and related instruments.6 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 to combine an eligible participant’s related instruments with listed index options, unlisted derivatives, options on exchange traded funds (ETF), index warrants and underlying instruments,7 and compute a margin requirement for such combined products on a portfolio margin basis.

The 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 SEC.8 Consistent with the NYSE and CBOE programs, the rule change is 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 group9 using computer modeling to perform risk analysis using multiple pricing scenarios. These scenarios are designed to measure the theoretical loss of the positions 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 rule change, a gain or loss on each position in the portfolio is calculated on each of 10 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 is between a market increase of 6 percent and a decrease of 8 percent. For non-highly capitalized broad-based indexes, the range is +/- 10 percent. For portfolios of equity options, narrow-based index options and/or security futures, the risk-array for computing the portfolio margin requirement is up/down market moves of +/-15 percent.
For options with 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 SEC-approved theoretical options pricing model is used to derive position values at each valuation point for the purpose of determining the gain or loss. 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 are 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 is the same that is permitted under SEC Rule 15c3-1a for computing a broker-dealer’s Net Capital. The margin requirement for each portfolio then is added together to calculate the total margin requirement for the portfolio margin account.

In addition, the rule change prescribes a minimum margin requirement of $0.375 for each listed option, unlisted derivative, security futures product, and related instrument multiplied by the contract or instrument’s multiplier.

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 no longer are required to compute a margin requirement for each individual position or strategy in a customer’s account.

Monitoring and Risk Management

As a pre-condition to permitting portfolio margining, a member is required to establish a comprehensive written risk analysis methodology to assess the potential risk to the member’s capital over a specified range of possible market movements. The written risk analysis methodology must include 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.

A member is required to periodically review its credit extension activities for consistency with its 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.
Approval Required to Use Portfolio Margin Methodology

A member that wishes to use a portfolio margin methodology must file an application with NASD, or the member’s designated examining authority (DEA) if other than NASD, and receive approval from NASD or the member’s DEA if other than NASD, prior to establishing a portfolio margin methodology for eligible participants. The application must be fully documented and should address, at minimum, the following:

a. Opening of portfolio margin accounts;
b. The profile of customers who will be eligible for portfolio margining, including the initial approval process to be applied by the firm;
c. A description of minimum equity requirements for each customer;
d. The determination, review and approval of credit limits for each customer and across all customers;
e. A description of any internal model used to determine risk in individual customer accounts, including the documentation for such model;
f. A description of correlation assumptions included in any internal models used for assessing the adequacy of margin in a customer's account;
g. A description of the stress testing scenarios that are performed on the accounts, the frequency of such testing and the results of the most recent stress test;
h. Monitoring of accounts to assess if the account contains a portfolio of hedged instruments;
i. Identification of security concentrations within an account;
j. Identification of concentrations in individual securities across customer accounts;
k. Intra-day monitoring of exposure in customer accounts;
l. Detection, prevention and circumvention of day trading requirements;
m. Monitoring of limitation on credit extended on portfolio margin accounts to 10 times the member’s Net Capital;
n. A description of the process for obtaining the TIMS theoretical values and the process used to compute margin requirements in individual customer accounts;
o. A description of house margin requirements if they differ from the TIMS requirement;
p. A description of exception reports that will be used to monitor margin exposure;
q. A description of the escalation procedures to alert senior management of unusual risks;
r. The regular review and testing of the risk analysis procedures by an independent unit such as internal audit or other comparable group;
s. If an organization would like to provide portfolio margin to customers in unlisted derivatives, the application should include a description of the products as well as a detailed description of the credit analysis and collateral management process that will be used to monitor any exposure that may result to the member. This information may be submitted to NASD at a later date if unlisted derivatives are not being offered to customers on the implementation date; and

t. An organizational chart identifying those persons primary responsible for portfolio margin risk management and the person or persons to whom they report.

Members seeking approval to participate in the portfolio margining pilot must submit the application providing the information set forth above to Susan M. DeMando, Associate Vice President, Financial Operations, 1735 K Street, NW, Washington, D.C. 20006. In order for members to be eligible for approval by the effective date of the pilot on April 2, 2007, the application must be submitted to NASD no later than March 2, 2007.

Eligible Participants

The rule change permits the following persons to engage in portfolio margining:
(1) any broker or dealer registered pursuant to Section 15 of the Exchange 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 an eligible participant subject to the five million dollar requirement falls below such minimum requirement, it must be restored within three business days. A member is 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 rule change, eligible participants are 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 is 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 are required to identify accounts that periodically liquidate positions to eliminate margin deficiencies. However, liquidation to eliminate margin deficiencies that are caused solely by adverse price movements may be disregarded.

Establishing Account

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

Under the rule change, 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 rule change, members are 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 will 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 subsequent Notice to Members to set forth the language required in the written disclosure statement.

Effective Date

The rule change establishes a pilot program that begins on April 2, 2007, and ends on July 31, 2007, to conform to the time periods of the similar portfolio margin pilot programs of the NYSE and CBOE.

As discussed above, members seeking approval to participate in the portfolio margining pilot must submit an application that includes the specified information to Susan M. DeMando, Associate Vice President, Financial Operations, 1735 K Street, NW, Washington, D.C. 20006. In order for members to be eligible for approval by the effective date of April 2, 2007, applications must be submitted to NASD no later than March 2, 2007.
Endnotes

1 See SR-NASD-2007-013 filed on February 12, 2007. Under Section 19(b) of the Securities Exchange Act of 1934, the SEC has the authority to summarily abrogate this type of rule change within 60 days of filing.


3 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.

4 For purposes of the rule, “security futures product” uses the definition at Section 3(a)(56) of the Exchange Act.

5 For purposes of the rule, the term “unlisted derivatives” is defined in Rule 2520(g)(2)(H).

6 For purposes of the rule, the term “related instrument” is defined in Rule 2520(g)(2)(D).

7 For purposes of the rule, the term “underlying instrument” is defined in Rule 2520(g)(2)(G).


9 Products would be grouped into a single portfolio that is based on the same index or issuer.

10 Currently, the only model that is approved by the SEC is The Options Clearing Corporation’s Theoretical Intermarket Margining System (TIMS).
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, 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:

<table>
<thead>
<tr>
<th>Portfolio Type</th>
<th>Up / Down Market Move (High &amp; Low Valuation Points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Capitalization, Broad-based Market Index²</td>
<td>+6% / -8%</td>
</tr>
<tr>
<td>Non-High Capitalization, Broad-based Market Index²</td>
<td>+/- 10%</td>
</tr>
<tr>
<td>Any other eligible product that is, or is based on, an equity security or a narrow-based index</td>
<td>+/- 15%</td>
</tr>
</tbody>
</table>

(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 (q)(4)(A) and (q)(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 (q)(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), $0.375 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 (q)(4)(A) through (q)(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 (q), 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 (q)
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.

1 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.

2 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).

3 See footnote 2.

* * * * *
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.