Notice to Members

MARCH 2007

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GUIDANCE

Portfolio Margin Risk Disclosure Statement

Portfolio Margin Risk Disclosure Statement and Written Acknowledgement to be Furnished to Customers Using a Portfolio Margin Account

Executive Summary

As announced in Notice to Members (NTM) 07-11 (February 2007), recent amendments to NASD Rule 2520 (Margin Requirements) permit members to margin certain products according to a prescribed portfolio margin methodology on a pilot basis. Related amendments to Rule 2860 (Options) 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. This Notice sets forth the language required for the written disclosure statement and acknowledgment pursuant to Rule 2860(c).

Member firms participating in, or planning to participate in, the Portfolio Margin Risk pilot program should refer to Attachment A of this Notice for sample disclosure and acknowledgement statements.

Questions/Further Information

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

On February 12, 2007, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a rule change to amend Rule 2520 (Margin Requirements) to permit members, on a pilot basis, to margin certain products according to a prescribed portfolio margin methodology. NASD also amended Rule 2860 (Options) 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 portfolio margin program will operate on a pilot basis starting 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. Details of these rule amendments and the related pilot program can be found in NTM 07-11.

As noted in NTM 07-11, Rule 2860(c) requires member firms 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 must 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. Attachment A of this Notice sets forth the language required in the written disclosure statement and acknowledgement.

Members seeking approval to participate in the portfolio margining pilot should refer to NTM 07-11 for details on the program and the application submission and approval process. As a reminder, applications should be submitted to Susan M. DeMando, Associate Vice President, Financial Operations, 1735 K Street, NW, Washington, DC 20006.

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.

2 The pilot period conforms to the time periods of substantially similar portfolio margin pilot programs of the New York Stock Exchange (NYSE) and the Chicago Board Options Exchange (CBOE), which were approved by the SEC. See Notice to Members 07-11.

3 The NYSE and CBOE also have adopted the disclosure document and acknowledgement set forth in Attachment A in connection with their respective portfolio margin programs.

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ATTACHMENT A

Sample Portfolio Margining Risk Disclosure Statement to Satisfy Requirements of NASD Rule 2520(g)

OVERVIEW OF PORTFOLIO MARGINING

1. 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 “security class” or “product group” as determined by an options theoretical pricing model using multiple pricing scenarios. These pricing 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.

2. The goal of portfolio margining is to set levels of margin that more precisely reflect actual net risk. The customer benefits from portfolio margining in that margin requirements calculated on net risk are generally lower than alternative “position” or “strategy” based methodologies for determining margin requirements. Lower margin requirements allow the customer more leverage in an account.

CUSTOMERS ELIGIBLE FOR PORTFOLIO MARGINING

3. To be eligible for portfolio margining, customers (other than broker-dealers or members of a national futures exchange) must be approved for writing uncovered options. If a customer (other than a broker-dealer or member of a national futures exchange) wishes to trade in unlisted derivatives, the customer must have and maintain at all times account equity of not less than five million dollars, aggregated across all accounts under identical ownership at the clearing broker. This identical ownership requirement excludes accounts held by the same customer in different capacities (e.g., as a trustee and as an individual) and accounts where ownership is overlapping but not identical (e.g., individual accounts and joint accounts). In addition to the requirements of the self-regulatory organization rule, carrying broker-dealers may have their own minimum equity requirement and possibly other eligibility requirements.

POSITIONS ELIGIBLE FOR A PORTFOLIO MARGIN ACCOUNT

4. All margin equity securities (as defined in Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System), warrants on equity securities or on indices of equity securities, equity-based or equity-index based listed options, and security futures products (as defined in Section 3(a)(56) of the Securities Exchange Act of 1934) are eligible for a portfolio margin account. In addition, a customer that has an account with equity of at least five million dollars may establish and maintain positions in unlisted derivatives (e.g., OTC swaps, options) on an equity security or index of equity securities that can be priced by a theoretical pricing model approved by the Securities and Exchange Commission (“SEC”).
5. A portfolio margin account may be either a separate account or a sub-account of a customer's standard margin account. In the case of a sub-account, equity in the standard account will be available to satisfy any margin requirement in the portfolio margin sub-account without transfer to the sub-account.

6. A portfolio margin account or sub-account will be subject to a minimum margin requirement of $.375 for each listed option, unlisted derivative and security futures product, multiplied by the contract's or instrument's multiplier, carried long or short in the account. Other eligible products are not subject to a minimum margin requirement.

7. A margin deficiency in the portfolio margin account or sub-account, regardless of whether due to new commitments or the effect of adverse market movements on existing positions, must be met within three business days. Failure to meet a portfolio margin deficiency prior to the end of the third business day will result in a prohibition on entering any new orders, with the exception of new orders that reduce the margin requirement. Failure to meet a portfolio margin deficiency by the end of the third business day will result in immediate liquidation of positions on the fourth business day, to the extent necessary to eliminate the margin deficiency.

8. Any shortfall in aggregate equity across accounts, when required, must be met within three business days. Failure to meet a minimum equity deficiency prior to the end of the third business day will result in a prohibition on entering any new orders, with the exception of new orders that reduce the margin requirement, beginning on the fourth business day and continuing until such time as the minimum equity requirement is satisfied or all unlisted derivatives are liquidated or transferred out of the portfolio margin account to the appropriate securities account.

9. When a broker-dealer carries a standard cash account or margin account for a customer, the broker-dealer is limited by rules of the SEC and of the Options Clearing Corporation (“OCC”) to the extent to which the broker-dealer may permit the OCC to have a lien against long option positions in those accounts. In contrast, the OCC will have a lien against all long option positions that are carried by a broker-dealer in a portfolio margin account, and this could, under certain circumstances, result in greater losses to a customer having long option positions in such an account in the event of the insolvency of the customer’s broker. Furthermore, the carrying broker-dealer has a lien on all long positions in a portfolio margin account, including margin equity securities, even if fully paid. Accordingly, to the extent that a customer does not borrow against long options and margin equity positions in a portfolio margin account or have margin requirements in the account against which the long options or margin equity securities can be credited, there is no advantage to carrying the long options and margin equity securities in a portfolio margin account and the customer should consider carrying them in an account other than a portfolio margin account.
10. Customers participating in portfolio margining will be required to sign an agreement acknowledging that their security positions and property in the portfolio margin account will be subject to the customer protection provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 and the Securities Investor Protection Act.

SPECIAL RISKS OF PORTFOLIO MARGIN ACCOUNTS

11. Portfolio margining generally permits greater leverage in an account, and greater leverage creates greater losses in the event of adverse market movements.

12. Because the maximum time limit for meeting a margin deficiency is shorter than in a standard margin account, there is increased risk that a customer’s portfolio margin account will be liquidated involuntarily, possibly causing losses to the customer.

13. Because portfolio margin requirements are determined using sophisticated mathematical calculations and theoretical values that must be calculated from market data, it may be more difficult for customers to predict the size of future margin deficiencies in a portfolio margin account. This is particularly true in the case of customers who do not have access to specialized software necessary to make such calculations or who do not receive theoretical values calculated and distributed periodically by an approved vendor of theoretical values.

14. For the reasons noted above, a customer that carries long eligible positions in a portfolio margin account could, under certain circumstances, be less likely to recover the full value of those positions in the event of the insolvency of the carrying broker.

15. Trading of margin equity securities, warrants on equity securities or on indices of equity securities, listed options, unlisted derivatives, and security futures products in a portfolio margin account is generally subject to all the risks of trading those same products in a standard securities margin account. Customers should be thoroughly familiar with the risk disclosure materials applicable to those products, including the booklets entitled “Characteristics and Risks of Standardized Options” and “Security Futures Risk Disclosure Statement”. Because this disclosure statement does not disclose the risks and other significant aspects of trading in security futures and options, customers should review those materials carefully before trading in a portfolio margin account.

16. Customers should consult with their tax advisers to be certain that they are familiar with the tax treatment of transactions in margin equity securities, warrants on equity securities or on indices of equity securities, listed options, unlisted derivatives, and security futures products, including tax consequences of trading strategies involving both security futures and option contracts.
17. The descriptions in this disclosure statement relating to eligibility requirements for portfolio margin accounts, and minimum equity and margin requirements for those accounts, are minimums imposed under the self-regulatory organization rules. Time frames within which margin and equity deficiencies must be met are maximums imposed under the self-regulatory organization rules. Broker-dealers may impose their own more stringent requirements.

18. Customers should bear in mind that the discrepancies in the cash flow characteristics of security futures and certain options are still present even when those products are carried together in a portfolio margin account. In addition, discrepancies in the cash flow characteristics of certain unlisted derivatives may also be present when those products are carried in a portfolio margin account. Both security futures and options contracts are generally marked to the market at least once each business day. Similarly, certain unlisted derivatives may also be marked to the market on a daily basis. However, there may be incongruity between each eligible product in that marks may take place with different frequency and at different times within the day. For example, when a security futures contract is marked to the market, the gain or loss is immediately credited to or debited from, respectively, the customer’s account in cash. While a change in the value of a long option contract may increase or decrease the equity in the account, the gain or loss is not realized until the option is liquidated, exercised, or assigned. Accordingly, a customer may be required to deposit cash in the account in order to meet a variation payment on a security futures contract even though the customer is in a hedged position and has experienced a corresponding (but yet unrealized) gain on an option. Alternatively, a customer who is in a hedged position and would otherwise be entitled to receive a variation payment on a security futures contract may find that the cash is required to be held in the account as margin collateral on an offsetting option position.

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Sample Portfolio Margining Acknowledgement

ACKNOWLEDGEMENT FOR CUSTOMERS

UTILIZING A PORTFOLIO MARGIN ACCOUNT

As discussed in the Portfolio Margining Risk Disclosure Statement, portfolio margining must be conducted in a margin account dedicated exclusively to portfolio margining. Portfolio margin accounts are treated as securities accounts carried with broker-dealers. As such, positions in portfolio margin accounts are covered by Rule 15c3-3 under the Securities Exchange Act of 1934, which protects customer accounts.

Rule 15c3-3 under the Securities Exchange Act of 1934 requires that a broker or dealer promptly obtain and maintain physical possession or control of all fully-paid securities and excess margin securities and maintain a special reserve account for the benefit of their customers. Fully-paid securities are securities carried in a cash account and margin equity securities carried in a margin or special account (other than a cash account) that have been fully paid for. Excess margin securities are a customer's margin securities having a market value in excess of 140% of the total of the debit balances in the customer's non-cash accounts. For the purposes of Rule 15c3-3, securities held subject to a lien to secure obligations of the broker-dealer are not within the broker-dealer's physical possession or control. The Securities and Exchange Commission (“SEC”) staff has taken the position that all long option positions in a customer's portfolio margining account may be subject to such a lien by the Options Clearing Corporation (“OCC”) and will not be deemed fully-paid or excess margin securities under Rule 15c3-3.

The hypothecation rules under the Securities Exchange Act of 1934 (Rules 8c-1 and 15c2-1) prohibit broker-dealers from permitting the hypothecation of customer securities in a manner that allows those securities to be subject to any lien or liens in an amount that exceeds the customer's aggregate indebtedness. However, all long option positions in a portfolio margining account will be subject to the OCC's lien, including any positions that exceed the customer's aggregate indebtedness. Furthermore, all long positions, including margin equity securities, in a portfolio margin account are held subject to a lien by the carrying broker-dealer, even if fully paid. The SEC staff has taken a position that would allow customers to carry positions in portfolio margining accounts even when those positions exceed the customer's aggregate indebtedness. Accordingly, within a portfolio margin account, to the extent that you have long option and/or margin equity securities positions that do not operate to offset your aggregate indebtedness and thereby reduce your margin requirement, you receive no benefit from carrying those positions in your portfolio margin account and incur the additional risk of the OCC's lien on your long option position(s) and the carrying broker-dealer's lien on all of your long positions.
Additionally, the Securities Investor Protection Corporation insures customer accounts against the financial insolvency of a broker-dealer in the amount of up to $500,000 to protect against the loss of registered securities and cash maintained in the account for purchasing securities or as proceeds from selling securities (although the limit on cash claims is $100,000).

BY SIGNING BELOW YOU AFFIRM THAT YOU HAVE READ AND UNDERSTOOD THE PORTFOLIO MARGINING RISK DISCLOSURE STATEMENT AND ACKNOWLEDGE AND AGREE THAT:

LONG POSITIONS IN A PORTFOLIO MARGINING ACCOUNT WILL BE EXEMPTED FROM CERTAIN CUSTOMER PROTECTION RULES OF THE SECURITIES AND EXCHANGE COMMISSION AS DESCRIBED ABOVE AND WILL BE SUBJECT TO A LIEN BY THE CARRYING BROKER-DEALER, AS WELL AS BY THE OPTIONS CLEARING CORPORATION WITH RESPECT TO LONG OPTION POSITIONS, WITHOUT REGARD TO SUCH RULES.

CUSTOMER NAME:

BY: __________________________ DATE: __________________________

(Signature/title)