CBOE
CHICAGO BOARD OPTIONS EXCHANGE

Timothy H. Thompson
Senior Vice President
Chief Regulatory Officer
Regulatory Services Division

Phone: (312) 786-7135
Fax: (312) 786-7982
Thompson@cboe.com

July 26, 2006

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Comment Letters Concerning the Chicago Board Options Exchange's Rule Filing to Expand Portfolio Margining (SR-CBOE-2006-14).

Dear Ms. Morris:

This letter provides a response by the Chicago Board Options Exchange (the "CBOE" or "Exchange") to public comment letters received by the Securities and Exchange Commission (the "SEC" or "Commission") concerning rule changes proposed by the CBOE that would provide a customer portfolio margining capability for margin equity securities, listed options, unlisted derivatives and security futures products.[1] These proposed changes would broaden and amend CBOE Rule 12.4 - Portfolio Margin and Cross-Margin for Index Options as necessary to incorporate the other instruments mentioned above, as well as to improve upon the rule.

The Commission received a total of six comment letters.[2] The comment letter submitted by the CBOE (dated June 5, 2006) was solely a response to the comment letter submitted by the Chicago Mercantile Exchange Inc (the "CME"). Therefore, no response to the CME comment letter is included herein.

The comment letters submitted by Fimat Group and The Options Clearing Corporation were supportive of the proposed rules, and do not necessitate a response or any remedial action on CBOE's part.

The comments of Stuart J. Kaswell of Dechert LLP, counsel to Federated Investors, focused solely on a contention that money market mutual funds should be allowed to be

[1] See Securities Exchange Act Release Number 53576 (March 30, 2006), 71 FR 17519 (April 6, 2006).
[2] Comment letters were received from:
Craig Donohue, Chief Executive Officer, Chicago Mercantile Exchange Inc.;
Stuart J. Kaswell, Dechert LLP, Counsel for Federated Investors;
Gary Alan DeWaal, Group General Counsel, Director of Legal and Compliance, Fimat Group;
Securities Industry Association (James Barry – Portfolio Margining Committee, John Vitha – Chair, Derivatives Product Committee and Christopher Nagy – Chair, Options Committee);
William H. Navin, Executive Vice President & General Counsel, The Options Clearing Corporation ;and
Timothy H. Thompson, Sr. Vice President, Chief Regulatory Officer, Chicago Board Options Exchange.

carried in a portfolio margin account for their collateral value, although not given portfolio margin treatment. The Securities Industry Association made the same comment. The CBOE agrees and intends to make an amendment to the proposed rules that would allow not only money market mutual funds, but also other non-equity securities, to be carried in a portfolio margin account subject to standard exchange margin requirements. This would enable a money market mutual fund to be used as collateral. The extension of margin on a money market mutual fund must otherwise comply with Commission rules, or an exemptive order thereunder.[3] Non-equity securities would, in effect, provide collateral in a portfolio margin account in the amount of 100% of their loan value (current market value less the standard exchange margin requirement). Margin would not be computed under a portfolio margin methodology.

The Securities Industry Association (the "SIA") made a number of comments and recommendations. The SIA strongly supports the currently proposed portfolio margining rules, but emphasizes that they are only a step forward, in that the ultimate goal of portfolio margining is "to enable qualified customers to maintain a single account in which virtually any financial product can be carried, and in which credit can be extended, subject to margin requirements that are determined on the basis of an SEC- or exchange-approved, risk-based methodology." The CBOE agrees and is committed, over time, and after carefully evaluating the operation of portfolio margining as proposed, to fostering appropriate changes to allow portfolio margining to reach its fullest potential. The SIA also advocates allowing broker-dealers to utilize their own risk analysis models for portfolio margining. The CBOE is not unwilling to consider the use of firm models at some point in the future. However, for now, the CBOE believes that the most prudent course is for all broker-dealers to utilize The Options Clearing Corporation model, to date the only model approved by the SEC.

The CBOE agrees with the SIA comment that the rule language in the New York Stock Exchange (the "NYSE") and CBOE rule filings should be substantively the same. The CBOE has had discussions with the NYSE and agreement has been reached on amendments that the CBOE believes will harmonize the filings, including improvements in consistency of terminology used. The CBOE expects that its amendment will be filed with the Commission within the next week or two. The SIA specifically noted that a term "OTC derivative" in the NYSE rule proposal differs from the term "unlisted derivative" used in the CBOE's filing. We believe that the NYSE will be amending its term to "unlisted derivative."

In its comment letter, the SIA requested that the CBOE eliminate its requirement for a separate cross-margin account and provide for one portfolio margin account for both

[3] See Section 11(d)(1) of the Securities Exchange Act of 1934 and Rule 11d1-2 thereunder. Also see exemption letter dated June 8, 2006, from Catherine McGuire, Chief Counsel, Division of Market Regulation, U.S. Securities and Exchange Commission, pursuant to delegated authority by the Commission and exemption request letter dated June 5, 2006, from Michael D. Udoff, Vice President, Associate General Counsel and Secretary, Securities Industry Association.

eligible securities and eligible index futures and options on index futures; eliminate its requirement that stock must be hedged in order to be carried in a portfolio margin; and eliminate its two-tiered per contract minimum margin requirement in favor of one, overall minimum. The CBOE agrees with the requested changes, believing that they are operationally desirable, would not result in negative consequences and are needed to be consistent with the NYSE's filing. The CBOE will amend its filing to reflect the changes called for in these comments.

As to the disclosure statement provided in the proposed rules, the SIA commented about differences between the NYSE and CBOE documents and requested that there be one uniform disclosure document. The CBOE is aware of the differences and is working with the NYSE to produce a uniform document. Removing the disclosure document from the rules is being considered. Instead, the NYSE and CBOE would issue an information memorandum and regulatory circular, respectively, to publish text of the disclosure statement and to notify members that it, or a substantively similar disclosure statement, must be delivered to customers opening a portfolio margin account. Also, in response to an SIA comment, the CBOE will consider the necessity of adding a disclosure to the effect that unlisted derivatives that are excluded by Section 301 of the Commodity Futures Modernization Act of 2000 from the definition of a security in Section 3(a)(10) of the Securities Exchange Act of 1934 have no assurance of coverage by the Securities Investor Protection Corporation ("SIPC") in the event of insolvency of the carrying broker-dealer/FCM.

In respect of the standards in the proposed rules that a member organization is expected to meet in performing a risk analysis of portfolio margin accounts, the SIA commented that it expects that the NYSE will take into account that a prime broker is unable to capture real time trading information in the case of a transaction effected by an executing broker. The CBOE would not expect transactions effected by executing brokers to be contemporaneously input into risk management systems. However, risk management procedures would be expected to take into consideration risk inherent in conducting a prime brokerage business.

The SIA suggests that rule language be incorporated that would give a DEA the ability to exempt specific transactions or classes of transactions from the five million dollar minimum account equity requirement if the limited risk characteristics of such transactions makes the account equity requirement unnecessary. As an example, the SIA cited a European style OTC collar as a strategy that should be exempt. The CBOE believes that in order to engage in unlisted derivative transactions in a portfolio margin account, a five million dollar account equity should be maintained, even if the transactions are viewed as having limited risk. The CBOE believes that the majority of accounts that would engage in unlisted derivative transactions have five million dollars in account equity and that the added regulatory measures needed to define which transactions should be exempt, and monitor compliance, are not justified.

The SIA commented that the rule proposals should allow a guarantee for the five million dollar minimum account equity requirement, provided that the guarantor is an affiliate of the owner of the guaranteed account. The SIA also seeks a provision allowing a guarantee for the margin requirement, at least in the case of a guarantor that is under common ultimate ownership. The SIA argues that NYSE Rule 431 permits guarantees for maintenance margin purposes, and given that Rule 431 governs portfolio margin accounts and not Regulation T, guarantees for margin should be permitted.

In its comment letter, the SIA objects to the per contract minimum requirement, arguing that in some cases the margin requirement will be greater than actual risk if the minimum applies. The SIA believes that the minimum is a crude and arbitrary approach, and is inconsistent with a true risk-based approach. Moreover, the SIA notes "the minimum could significantly undermine the usefulness of the portfolio margin account for significant groups of clients." The SIA contends that proprietary risk monitoring programs utilized by broker-dealers adequately capture the risk on a real time basis, making the proposed minimum ($.375 times the contract multiplier, per contract) unnecessary or, at least, excessive. The SIA proposes that the minimum be lowered to $.125 if at least a five million dollar account equity is maintained or the broker-dealer employs a volatility stress test of +/- 20%.

The CBOE believes that the SIA's comments concerning account guarantees and the per contract minimum have some merit. However, at this time, the CBOE believes that it would be prudent to disallow account guarantees and to employ a $.375 minimum given that portfolio margining is being introduced to customer accounts for the first time. The CBOE prefers to evaluate the operation of portfolio margining before considering any modification of the current proposal.

The SIA further commented that proposed risk monitoring procedures for portfolio margin accounts that include reference to limits on credit extensions (proposed CBOE Rule 15.8A) should not be interpreted to mean that a firm must set a specific dollar amount as a limit for a particular customer. The CBOE agrees that the provision should not be interpreted as requiring a specific dollar limit on how much credit may be extended (i.e., the amount of a debit balance). Firms should be allowed to evaluate the risk of the portfolio margin account overall, and the debit balance should be just one of the criteria a firm should take into consideration.

The CBOE will propose an amendment to allow excess equity in a regular margin account to meet a margin deficiency in a portfolio margin account, provided the portfolio margin account is a sub-account of the regular margin account. The SIA proposed this in its comment letter.

Lastly, there is an SIA comment urging the CBOE to eliminate its requirement to transfer long options out of the portfolio margin account if there are no other positions except long options in the account. Long options are subject to a lien when carried in a portfolio margin account, even if paid for in full. In response to this comment, and in view of agreement expressed by SEC staff to the NYSE, the CBOE will propose an amendment to eliminate the requirement. The fact that all long positions in a portfolio margin account are subject to lien is disclosed to customers in a written disclosure statement that is require to be provided to customers at or prior to the first transaction in a portfolio margin account. A customer has the ability to instruct the carrying broker-dealer/FCM to transfer a position or positions out of a portfolio margin account if the customer does not want them subject to a lien.

If the Exchange can provide anything further, please feel free to contact the undersigned or James Adams, Director, Department of Member Firm Regulation, at (312) 786-7718.

Sincerely,

Timothy Thompson

Timothy H. Thompson

cc: Mr. Michael A. Macchiaroli
Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission

Randall W. Roy
Branch Chief
Division of Market Regulation
U.S. Securities and Exchange Commission

Joanne Moffic-Silver
General Counsel
Chicago Board Options Exchange