

## REGULATORY CIRCULAR RG02-110

Date: December 10, 2002

To: Members and Member Firms

From: Department of Financial and Sales Practice Compliance

Subject: iShares S&P 500 Fund® (IVV)  
Margin Accounts - Writing Index Options on a Covered  
Basis and Eligibility for Covered Writing Approval Level

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PLEASE ROUTE TO: COMPLIANCE DEPARTMENT  
OPTIONS DEPARTMENT  
MARGIN DEPARTMENT  
SENIOR REGISTERED OPTIONS PRINCIPAL  
COMPLIANCE REGISTERED OPTIONS PRINCIPAL

### KEY POINTS

- In a margin account, S&P 500 (SPX) options may be written on a “covered” basis against an equivalent offsetting position in the iShares S&P 500 Fund (IVV).
- The writing of SPX options in a cash account against an equivalent offsetting position in the iShares S&P 500 Fund is not currently permitted.
- A firm can consider a customer margin account that is approved for “covered call writing” to also be approved for writing SPX calls on a covered basis provided the firm’s written procedures so specify.
- As a reminder, it is important to understand that due to the cash settlement feature of SPX options and the “timing risk” involved, there is an inherent limitation on the ability of writers of SPX options to cover their risk exposure by holding a position in the iShares S&P 500 Fund.

## BACKGROUND

The Exchange is hereby approving the iShares S&P 500 Fund as an instrument against which short S&P 500 index options ("SPX") may be written on a covered basis in a margin account.<sup>1</sup>

Shares of the iShares S&P 500 Fund, while not deliverable upon exercise / assignment, will for margin purposes, be considered an underlying security for the corresponding index options. Currently, 1 SPX option contract is equivalent to 1,000 shares of the iShares S&P 500 Fund.

Therefore, in a margin account, no margin is required on an SPX call option carried short if it is offset, or "covered", by an equivalent long position in the iShares S&P 500 Fund. Similarly, no margin is required on an SPX put option carried short when it is offset, or "covered" by an equivalent short position in the iShares S&P 500 Fund. In respect of short calls, the offsetting long position must be valued at current market value or the call exercise price, whichever is lower. In the case of short puts, any amount (aggregated) by which the exercise price of the put exceeds the current market value of the offsetting short position must be added to the margin requirement on the offsetting short position.

The iShares S&P 500 Fund is not approved at this time as an instrument against which, in a cash account, SPX options may be written and considered covered under the Exchange's margin rules.

### Risk Considerations

While short options on a broad-based market index offset with an equivalent position in a Unit Investment Trust ("UIT") or open-end mutual fund ("Fund") that replicates the same index may be treated as "covered" for margin purposes,<sup>2</sup> the UIT or Fund **cannot** be delivered (received) to meet an assignment obligation. Therefore short index options offset with equivalent UITs or Funds are not covered in the same sense as the writing of a covered call or put on an individual stock. Exchange traded index options are cash-settled. An assignment on a short index option results in a cash debit to an account for the in-the-money amount. The in-the-money amount is determined based upon an index value (the "exercise settlement value"), which is calculated at a set point in time. In respect of a short call option, the respective long UIT or Fund must be salable at a price equal to or greater than the exercise settlement value in order to properly offset the debit.<sup>3</sup> Following the point in time at which an exercise settlement value is determined and prior to the time at which an assignment notice is

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<sup>1</sup> See Exchange Rule 12.3(c)(5)(C)(2).

<sup>2</sup> Provided there is specific Exchange approval.

<sup>3</sup> In the case of a short put option, the investor must be able to purchase the respective UIT or Fund for delivery against the short position at a price which is less than or equal to the exercise settlement value.

received for a short, in-the-money index call option, the market price of the corresponding UIT or Fund, may decline. This “timing risk” is an inherent limitation on the ability of writers of cash settled index options to cover their risk exposure by holding positions in the underlying interest.

Options with an American-style exercise feature (e.g., OEX) can be exercised at any time prior to their expiration.<sup>4</sup> Options with a European-style exercise feature, such as SPX, can be exercised only during the exercise period, which begins on the business day just prior to the expiration date. Thus, except for the day on which they become exercisable, assignment risk is not as great a concern for European-style options as it is with American-style options.

Writers of index options are advised to review Chapter 10 - Principal Risks of Options Positions of the booklet Characteristics and Risks of Standardized Options (the options disclosure document) for an explanation of other risk factors.

#### Approved Strategy Level

For account approval purposes, margin accounts approved for covered call writing on individual stocks will be deemed by the Exchange as approved to write call options on a broad-based market index versus an equivalent position in a corresponding UIT or Fund<sup>5</sup> provided that a firm’s written supervisory procedures specify that the covered equity call writing approval category encompasses approval for writing index call options on a covered basis against a UIT or Fund replicating the same index. A firm may also establish a dedicated approval item.

Pursuant to Exchange Rule 9.9, no member, Registered Options Principal or Registered Representative shall recommend to a customer the purchase or sale (writing) of any option contract unless the person making the recommendation has a reasonable basis for believing at the time of the recommendation that the customer has such knowledge and experience in financial matters that he/she may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

Questions regarding this Regulatory Circular should be directed to Rich Lewandowski at (312) 786-7183 or Jim Adams at (312) 786-7718.

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<sup>4</sup> In Regulatory Circular RG00-171, dated Nov. 8, 2000, the Exchange approved the iShares S&P 100 Fund as an instrument against which short OEX options may be written on a covered basis in a margin account. OEX options are American-style exercise. Therefore, short positions are capable of being assigned at any time prior to expiration.

<sup>5</sup> The UIT or Fund must be specifically approved by the Exchange.