

Regulatory Circular RG04-110

To: The Membership

From: Division of Regulatory Services

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Subject: Margin and Net Capital Requirements
for Options on the CBOE China Index

Exchange Rich Lewandowski (312) 786-7183
Contacts: James Adams (312) 786-7718

KEY POINTS

- The Chicago Board Options Exchange ("CBOE") expects to list and trade options on the CBOE China Index on November 8, 2004.
- For margin purposes, the CBOE China Index is treated as broad-based.
- For net capital purposes, the CBOE China Index is treated as a broad-based, non-high capitalization index.

DISCUSSION

The CBOE expects to list and begin trading options on the CBOE China Index (symbol "CYX") on November 8, 2004. CYX options will be cash-settled and European-style exercise.

The CYX is a broad-based, equal dollar weighted index composed of 16 securities that are either American Depositary Receipts ("ADRs"), New York Registered Shares ("NYSS") or New York Stock Exchange Global Shares® ("NGSS"). The ADRs are traded on either the NYSE, NASDAQ Stock Market or American Stock Exchange, while the NYSSs and NGSSs are traded only on the New York Stock Exchange.

The CYX index will be rebalanced quarterly (after the close of trading on the third Friday of March, June, September and December). The base date for CYX is December 15, 2000, when the index level was set to equal 50.

MARGIN

In accordance with CBOE Rule 12.3(c)(4), purchases of puts or calls with 9 months or less until expiration must be paid for in full. For purchases of puts or calls with more than 9 months until expiration, it is required that 75% of the total cost (option current market value) be deposited (maintained). When time to expiration reaches 9 months, the option no longer has value for margin purposes.

CYX options are considered broad-based for margin purposes and option writers are subject to the margin requirements specified in CBOE Rule 12.3 (c)(5). The initial and maintenance margin requirement for a short put or call on a broad-based index is 100% of the option proceeds* plus 15% of the aggregate contract value (current index level x \$100) minus the amount by which the option is out-of-the-money, if any, subject to a minimum for calls of option proceeds* plus 10% of the aggregate contract value and a minimum for puts of option proceeds* plus 10% of the aggregate exercise price amount. (*For calculating maintenance margin, use current market value instead of option proceeds.)

In a margin account, no margin need be required in respect of a CYX call option carried in a short position that is covered by a long position in equivalent units of an “underlying stock basket” as defined in CBOE Rule 12.3(a)(7). Correspondingly, no margin need be required in respect of a CYX put option carried in a short position that is offset by a short position in equivalent units of an underlying stock basket. In computing margin on the underlying stock basket, the current market value used shall not be greater than the exercise price in the case of a short call. In the case of a short put, in computing margin on the underlying stock basket, margin shall be the amount required by CBOE Rule 12.3(b)(2), plus any amount by which the exercise price of the put exceeds the current market value of the underlying stock basket.

Where a short option contract is covered by an “escrow agreement” meeting the requirements of CBOE Rule 12.3(d)(2), no margin need be required.

Spreads and straddles are permitted for options covering the same number of shares of the same underlying index. Members should be aware that due to their exercise feature, it is possible for European-style options to trade at a discount to their intrinsic values. It is possible that the spread margin held by the carrying broker could become insufficient to cover the assignment obligation on the short option if the customer is unable to exercise the long option and it is trading at a discount to its intrinsic value.

OPTION MARKET-MAKER MARGIN REQUIREMENTS

Pursuant to CBOE Rule 12.3(f), market-makers in CYX options are allowed “permitted offset” treatment for qualified stock baskets. The basket must contain no less than 50% of the capitalization in the index in order to qualify as a permitted offset.

NET CAPITAL

CYX is considered a broad-based, non-high capitalization index for net capital purposes.

Under risk-based haircuts, the haircut is equal to the maximum potential loss for all CYX option positions calculated over a range of index movements of -10% /+10% for options market-makers, and -15%/+15% for all other all broker-dealers. All positions are subject to a minimum charge of \$25 per contract.¹ CYX options will be included in the China Index product group.

Under risk-based haircuts, an offset is permitted between CYX options and a qualified stock basket. The stock basket must represent not less than 50% of the capitalization of the index. A 95% offset between the qualified stock basket and the options will be applied with a minimum charge equal to 7.5% of the market value of a qualified CYX basket.

Additionally, under risk-based haircuts, an offset is permitted between CYX options and futures contracts on the CBOE China Index (traded on the CBOE Futures Exchange).

For those firms not utilizing risk-based haircuts, the haircut will be calculated pursuant to SEC Rule 15c3-1a(b).

Questions regarding the margin and capital treatment of CYX options should be directed to Rich Lewandowski at (312) 786-7183 or James Adams at (312) 786-7718.

Footnotes

¹ Risk-based haircuts may be applied pursuant to SEC Rule 15c3-1a (Appendix A).