Regulatory Circular RG09-141

To: Members

From: - Division of Member and Regulatory Services
- Legal Division

Date: December 4, 2009

Subject: Alternative Margin Treatment Available for Writing Listed Equity Call Options Against Employee Stock Options

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KEY POINTS

- On June 17, 2009, the Securities and Exchange Commission (the "SEC" or "Commission") approved Exchange customer margin rules that provide for spread margin treatment on the writing of listed equity call options when, for the same underlying security and underlying quantity of shares, the writer owns employee stock options that are vested and exercisable ("vested and exercisable employee stock option" or "VESO").[1]

- In order to utilize this rule provision, the owner of the VESOs (account holder), the member organization (carrying broker-dealer) and the issuer of the VESOs must complete documentation and comply with the terms and conditions proscribed by the Exchange in such form, format and procedures as may be established by the Exchange from time to time.

- The rule also requires the execution of a written agreement between the account holder, broker-dealer and issuer. This tri-party agreement must contain certain representations and stipulations of each party. Additionally, the agreement must be in a form acceptable to the Exchange.

- The "Master Vested Stock Option Monetization Agreement" created by iOptions Group LLC is one such form that is acceptable to the Exchange. Interested parties must contact iOptions Group regarding permission to utilize its agreement form.

- Member organizations that wish to create their own agreement forms must submit them to the Exchange for a determination of acceptability prior to utilizing the new margin provisions.

[1] As required for spread margin treatment, the long option (VESO) cannot expire before the short call option. Also, the amount (if any) by which the exercise price of the long option (VESO) exceeds the exercise price of the short call option (in aggregate) must be held in or deposited to the account.

- Before applying the permitted spread margin treatment, a legal opinion in respect of each issuer must be obtained regarding the account holder's and the issuer's legal right to enter into the transactions under the terms required in the written agreement in view of the issuer's stock option plan and related documents.

- Member organizations that operate pursuant to this rule provision are required to compute the uncovered option margin requirement on the listed equity call options involved and deduct that amount from net capital.

DISCUSSION

An Exchange margin rule is now in effect that permits spread margin treatment when listed equity call options are written against vested and exercisable employee stock options ("VESOs") for the same underlying security and quantity of shares. Previously, a VESO has never been allowed any consideration in respect of the margin required to write a listed equity call option on the same equity security that underlies the VESO. Thus, an owner of VESOs that writes listed equity call options had to meet the uncovered (naked) option margin requirement.

In order to utilize this rule provision, the owner of the VESOs (account holder), the member organization (carrying broker-dealer) and the issuer of the VESOs must complete such documentation and comply with such terms and conditions proscribed by the Exchange in such form, format and procedures as may be established by the Exchange from time to time. By rule, the execution of a written agreement between the account holder, broker-dealer and issuer, setting forth the representations, stipulations, responsibilities and obligations of each, is required. This tri-party written agreement must be in a form acceptable to the Exchange. While the written agreement must address all relevant contingencies, most importantly it must:

- convey an irrevocable power-of-attorney to the broker-dealer to exercise the VESOs if the listed call options are assigned or if the broker-dealer determines it is necessary,[2]

- obligate the issuer to accept exercise instructions from the broker-dealer, and

- obligate the issuer to promptly deliver the underlying securities to the broker-dealer upon payment or receipt of the exercise notice from the broker-dealer within a period proscribed by the Exchange. In this regard, in the event of an assignment of listed call options necessitating the exercise of VESOs, the Exchange expects broker-dealers and issuers to have adequate procedures to enable the broker-dealer to receive the underlying securities by settlement date of the assignment.[3]

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[2] The irrevocable power-of-attorney may also be used in the event the account holder wishes to close the listed option position prior to its expiration and instructs the broker-dealer to exercise that number of VESOs necessary to cover the cost of the closing purchase (the account holder may also have the option of depositing additional cash in the account holder's account to cover the cost of the closing purchase).

[3] Assignment of option exercises are generally made by The Options Clearing Corporation at or before 8:00 AM central time on the settlement date following the day of exercise. The stock transaction resulting from an assignment settles on the third settlement day following the day of exercise, which is generally the second settlement day following the date of assignment. Broker-dealers are still required to comply with the delivery requirements of Rule 204 of Regulation SHO in the event of an assignment of listed calls, even if securities due from an issuer upon exercise of VESOs are not received by the settlement date of the assignment.

Additionally, the agreement (or supplemental written agreement(s)) must include:

- a pledge by the account holder to the broker-dealer of the VESOs and, in the event the VESOs are exercised, of the underlying securities;
- a waiver by the issuer of forfeiture conditions that otherwise might apply to the VESOs and of any transfer restrictions that would preclude a pledge of VESOs to the broker-dealer; and
- a representation by the issuer that the VESOs are covered by an effective registration statement on Form S-8.[4]

The Exchange has determined that the "Master Vested Stock Option Monetization Agreement" created by iOptions Group LLC is an acceptable agreement form. Interested parties must contact iOptions Group regarding permission to utilize its agreement form[5].

Member organizations that wish to create their own agreement forms must submit them to the Exchange for a determination of acceptability prior to utilizing the new margin provisions.

Additional terms and conditions that have been imposed by the Exchange under the new margin rule are as follows:

- before applying the permitted spread margin treatment, a legal opinion in respect of each issuer must be obtained regarding the account holder's and the issuer's legal right to enter into the transactions under the terms required in the written agreement, in view of the issuer's stock option plan and related documents; and
- member organizations that operate pursuant to this rule provision are required to compute the uncovered option margin requirement on the listed equity call options involved and deduct that amount from net capital.

For additional information, please refer to Rule 12.3(c)(10) and Rule Filing No. SR-CBOE-2008-55, which are located at www.cboe.org/legal. Questions concerning this Regulatory Circular may be directed to Jim Adams, (312) 786-7718, in the Exchange's Department of Member Firm Regulation or Jennifer Lamie, (312) 786-7576, in the Exchange's Legal Division.

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[4] If the registration statement becomes ineffective, the issuer must notify the broker-dealer immediately.

[5] iOptions Group LLC, Attention: Ms. Colleen Sullivan, csullivan@ioptionsgroup.com, 312-953-8495.