

Regulatory Circular #RG91-64

Date: November 22, 1991

To: Select Member Organizations

From: Department of Financial Compliance

Re: Debit Put Spread Pilot Program

The Chicago Board Options Exchange ("CBOE" or "Exchange") has filed with the Securities and Exchange Commission for a pilot program for qualified put spreads to be effected in the cash account with the deposit of the net debit. The Exchange is currently accepting the enclosed application in anticipation of a December 4, 1991 start date. For purposes of this pilot, qualified put spreads are those that are comprised of exchange traded, European-style index options¹ where both puts expire simultaneously and the long leg has a greater strike price than the short option (a.k.a. debit or bear put spreads).

The purpose of the pilot is to provide customers with more flexibility in hedging the risks of their portfolios through expanding the use of cash account transactions. In order to participate in the pilot, customers must have a portfolio of long stocks, or securities that can be readily and economically converted into common stocks, in at least four industry groups and containing at least 20 stocks, none of which account for more than 15% of the value of the portfolio. The value of the portfolio must at a minimum be equal to the aggregate underlying index value of the short puts in the spread. The portfolio must at all times meet these standards notwithstanding any trading activity.

Participating customers must have the approval of the CBOE's Department of Financial Compliance, which is obtained by the submission of the following information:

1. a completed debit put spread exemption application form;
2. a copy of the qualified portfolio that will be hedged by the spread, which lists the stocks and respective number of shares in the portfolio by industry group;
3. the total market value of the portfolio and the portion of the portfolio that is hedged by the debit put spread;
4. the number of contracts and series of the options in the debit put spread.

¹To date, only the following options may be used in this pilot: NSX, SPL, SPX, LSW and LSX, all of which are cash settled, European-style index options based on the S&P 500 index.

Items #3 and #4 must be updated and sent to the CBOE on each Monday following expiration.²

Participants should be aware that additional information may be requested at any time by the CBOE and that it may review the applicant's books and records to assure itself that the spreads are bona fide hedges. The CBOE will be required to submit a report to the SEC within nine months of the inception of the pilot program analyzing its effectiveness. As a result, it is probable that detailed information from pilot participants will be requested periodically. All information submitted to the CBOE is confidential.

Diane Malley and Carolin Henderson, of the Exchange's Financial Compliance Department, may be contacted at (312)786-7924 or (312)786-7943, respectively for pilot applications and/or questions regarding the pilot program.

Outlined below are a few key points regarding the practical applications of the pilot program.

Acceptable Strategies: The pilot program will permit only two hedge strategies utilizing debit spreads to be effected in the cash account with the deposit of the net debit.

1. **Qualified debit put spread associated with a long qualified equity portfolio (a.k.a. modified protective put).** The deposit requirement is equal to the cost of the long put position less the proceeds from the sale of the short put, or the net debit. In no case are the securities required to be maintained with the broker-dealer.
2. **Qualified debit put spread and short index calls associated with a long qualified equity portfolio (a.k.a. modified hedgewrap or fence).** The deposit requirement is equal to the purchase price of the long put(s) minus the sale proceeds of the short put(s) and call(s) in addition to the deposit of an Options Clearing Corporation Market Index Option Escrow Receipt, on behalf of the short call(s), secured by acceptable collateral equal to the aggregate underlying index value as of the close of trade date of the calls. (Refer to Exchange Rule 24.11, which describes the application of Market Index Option Escrow Receipts.)

Legging Into a Qualified Debit Put Spread: The initial spread deposit requirement of the net debit applies when the components of the spread are effected on the same day and when a short put position is added to a pre-existing, fully paid for, long put position. If the spread is created by first "legging" into the short put position, the separate initial requirements must be met for each component. Once met, however, the position may be maintained at the spread deposit requirement.

Legging Out of a Qualified Put Spread: Before an order is accepted to close out the long leg of a spread, the broker must be assured that the customer is prepared to fully collateralize the

²Pilot participants who are also hedge exemption customers pursuant to the CBOE's position limit rules (CBOE Rule 24.4) need only submit the required monthly information to the Department of Market Surveillance with a request that the data be forwarded to the Department of Financial Compliance for initial and continued approval of a debit put spread exemption.

short leg. A put guarantee letter or cash/cash equivalents equal to the aggregate short put(s) strike price must be deposited under all circumstances, even when the puts expire worthless the day after the long leg is sold.

(RG91-51 Revised)

No statement in this memorandum is to be construed as a recommendation to buy or sell securities or to provide investment advice. Options, like all investment, entail both risks and rewards and may not be suitable for all investors. Before buying or selling an option a person must receive a copy of Characteristics and Risks of Standardized Options.