

Regulatory Circular RG93-32

Date: May 13, 1993
To: The Membership
From: Department of Financial Compliance
Subject: Capital and Margin Requirements for Sector Index Options

On May 24, 1993 the Chicago Board Options Exchange ("CBOE") will begin to trade options on eight (8) industry indexes ("Sector Indexes")¹. The Sector Indexes are narrow-based, cash settled, European-style, price-weighted indexes comprised of fifteen (15) to thirty-three (33) domestic securities. The underlying securities trade on either the New York or American stock exchanges or the National Association of Securities Dealers Automated Quotations System. This circular describes and explains the margin and capital treatment applicable to transactions in Sector Index options.²

MARGIN

Sector Index options are considered narrow-based options for margin purposes and are subject to the margin requirements specified in CBOE Rule 24.11(b)(ii). An industry index option is treated in the same manner as an individual stock option for Exchange margin purposes. A long option position must be paid for in full. The margin requirement for a short put or call will be 100% of the option premium plus 20% of the underlying index value, less the out-of-the-money dollar amount, if any, to a minimum of 100% of the premium plus 10% of the underlying index value. Spreads and straddles will be permitted for options covering the same number of shares of the same underlying index. Members

¹ Standard & Poor's® ("S&P") Chemical Index, S&P Health Care Index, S&P Retail Index, S&P Transportation Index, S&P Banking Index, S&P Insurance Index, CBOE Environmental Index, and CBOE Computer Software Index.

²Exchange options margin requirements are applicable to all public customer positions and the non-market maker positions of non-clearing broker-dealers. Capital requirements ("haircuts") are applicable to the positions of all broker-dealers as described herein and in SEC Rule 15c3-1.

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

With the concurrence of the staff of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission ("SEC") has issued a no-action letter allowing good faith credit to be extended to transactions of options market-makers in securities underlying the Sector Indexes in accordance with the "permitted offset" provisions of Regulation T, Section 220.12. For a basket to qualify as a permitted offset position, it must be comprised of all of the securities in the underlying index in exact proportion to the index.

CAPITAL

For capital purposes, the Sector Index options will be treated as narrow-based options. For example, the haircut on a short position will be:

- 75% of the current market value with a minimum haircut of \$75 per contract for market-maker positions.
- 100% of the current market value with a minimum of \$150 per contract for firms utilizing the proprietary haircuts described in the October 23, 1985 no action letter to the Securities Industry Association Capital Committee.
- 15% of the underlying index value, less the out-of-the-money amount, plus the prescribed net worth adjustment which is an add back equal to the time value of the short contract, for firms computing haircuts under Appendix A of SEC Rule 15c3-1. The minimum haircut is \$250 per contract less the aforementioned net worth adjustment.

Additionally, at the request of the Exchange, the SEC has agreed that basket haircut treatment³ will be available to Sector Index options and offsetting securities baskets, when the broker-dealer

³ Basket haircut treatment is provided for and described in a February 27, 1986 letter from Michael Macchiaroli of the SEC to David Marcus of the New York Stock Exchange. The haircut for a Sector basket offset by options is the greater of a) the haircut pursuant to paragraph (c)(2)(x) of SEC Rule 15c3-1 or b) 5% of the value of the securities basket position.

holds positions in all of the component securities in equal proportion as represented in the index.

Questions regarding the margin and capital treatment of Sector Index options should be directed to Diane Malley at (312) 786-7924 or Rich Lewandowski at (312) 786-7183.