Regulatory Circular RG93-18

To: Member Firm Compliance Departments
Member Firm Margin and Credit Departments
Senior Registered Options Principals
Compliance Registered Options Principals
Trading Floor Operations Managers

From: Regulatory Services Division

Date: February 24, 1993

Re: Regulatory Requirements for Flexible Exchange Options ("FLEX")

This memorandum is intended to address a number of regulatory issues that Member Firms should be aware of in connection with the start of trading in Flexible Exchange Options ("FLEX"). FLEX Options on the S&P 100 and 500 indices have been approved by the Securities and Exchange Commission and are scheduled to begin trading on February 26, 1993. Transactions in FLEX Options traded on the CBOE generally will be subject to the same rules that apply to index options traded on the CBOE. However, in order to provide investors with the flexibility to designate certain terms of the options and to accommodate other special features of FLEX Options, rules and certain procedures designed for FLEX Options are necessary. This circular is not all inclusive and the reader should refer to Chapter 24A Flexible Exchange Options, of the CBOE Constitution and Rules.

Trading Practices

The initial trading hours for FLEX will be from 9 am until 3:15 pm (Central Time)[1]. There will be no trading rotations, either at the opening or at the close of trading. FLEX Options are designed to provide some of the same advantages of the current Over-The-Counter ("OTC") equity derivative market by allowing the parties to a transaction to select certain of the terms of the option contract. FLEX contracts shall be denominated for settlement in U.S. dollars only, and shall be cash settled. Every Request For Quotes ("RFQ") and every FLEX contract must include one element from each of the following contract term categories:

1) Underlying index; 2) Expiration date (must be no more than 5 years and cannot expire within three business days of a regular third-Friday expiration for any non-FLEX index option other than a QIX option); 3) Exercise style - American, European or Capped; 4) Exercise price - specified in terms of a specific index value number, a method for fixing such a number at the time a FLEX Quote is accepted, or a percentage of index value calculated as of the open or close of trading on the Exchange on the trade date, and the

[1] All times are Central Time.

cap interval in the case of a capped option; 5) Exercise settlement value - the index value reported at the close or at the open of trading on the Exchange or a specified average, provided that any average index value must conform to the averaging parameters established by the SPX Floor Procedures Committee: and 6) Type,-put, call or spread (spreads may be traded at a net debit or credit, each leg in the spread will be priced separately for clearing purposes).

Trading in FLEX Options will differ from normal option trading. The procedure outlined below will apply to all option series to be created:

- The submitting member will bring a RFQ to the post on a form developed by the Exchange, specifying each of the terms listed above as well as the time period for quote responses, whether a bid, offer or both is sought, and whether the quote is to be stated in the form of a fractional price, specific dollar amount or a percentage of the underlying value, and whether the price is contingent upon specific factors in other markets. Additionally, the member must disclose if the order is intended to be crossed. Generally, the underlying (notional) value represented by a transaction that creates a new FLEX series must be at least $10,000,000.

- The submitting member will present the RFQ to the FLEX Post Official for dissemination to the trading floor and vendors. The Post Official will use a PC-based program to review the RFQ to assure that the terms of the contract are within the parameters specified.

- Quotes will be made by open outcry at the Post, during the time allotted for responses to the request. Price and time priority rules apply to quotes. No transaction may take place until after the specified time period has expired. Quotes may be modified or withdrawn, (subject to special limitations imposed on appointed market-makers in Rule 24A.9) by public outcry during the specified response time.

- The submitting member will then decide whether to accept the best quotes. If the best bid or offer ("BBO"), is rejected, or if the BBO is for less than the size requested, FLEX participants other than the submitting member may, during the BBO improvement interval, match or improve, as applicable, the BBO. The submitting member is not obligated to accept any FLEX bid or offer. If the submitting member previously has indicated its intention to cross or act as principal, he must, prior to the BBO improvement interval, indicate at the Post the price at which he expects to trade. If the submitting member then matches or improves the BBO during the BBO interval period, the trading priority principals will apply. If the crossing price is better than the best quote, the submitting member may retain the entire order unless a participating market-maker(s) matches the crossing price, in which case the market-maker(s) may take up to 1/3 of the order; if the cross matches the best quote, the submitting member may retain 1/2 and the market-maker(s) split the remaining 1/2.

- Upon acceptance of a quote, the Post Official will complete the transaction on the PC- based system and generate a trade confirmation on the PC-based system for the parties involved. Both parties must sign the trade confirmation ticket and return it to the Post Official. Upon receipt of the signed trade confirmation, a last sale report will be sent to OPRA.

- Once a series has been created it may be traded in the secondary market in increments of $1,000,000 of the aggregate underlying index value. Quotes will be provided on request and secondary trading will be conducted in the same fashion as a series-creating transaction.

Sales Practices

Disclosure Requirements

Member firms should be aware that Exchange Rule 9.15 requires that a customer be furnished with a copy of an amendment to the current Options Disclosure Document ("ODD") regarding this product. Member firms are required to deliver the amendment no later than at the time the first confirmation of a transaction in FLEX Options is delivered to a customer.

Member firms may comply with this requirement in various ways, including but not limited to one of the following:

(1) A firm may choose to conduct a mass mailing of the amendment to all of its options approved customers who have already received the ODD.

(2) A firm may deliver the amendment to a customer, who has already received the ODD, with the first confirmation of a FLEX Options transaction.

All other sales practices rules, as detailed in Chapter IX, are in effect for FLEX options.

Deposit and Margin Requirements

Deposit and margin requirements for FLEX Options are similar to those for broad-based market index options, which are discussed in CBOE Rule 24.11. Long FLEX Options must be paid for in full. Short FLEX Options have a margin requirement of 100% of the current option market value plus 15% of the current underlying index value less the out-of-the-money amount, if any, to a minimum of 100% of the current option market value plus 10% of the current index value times the index multiplier.

Spreads and combinations will be permitted for margin purposes between FLEX Options with different settlement value terms and/or traditional index options on the same underlying index. FLEX contracts offer the investor five (5) possible choices as previously noted by which the expiration settlement value may be determined:

1. Index values reported at the close of trading on the Exchange,

2. Index values reported at the open of trading on the Exchange,

3. A specified average of the index values reported at the open and close of trading at the Exchange,

4. A specified average of the high and low index level, as determined by S&P,

5. an average of the index value reported at the opening, the reported index value at the close, and the high and low index levels.

Settlement values two (2) through five (5) above are only available on expiration date. If the options are assigned on any other day the settlement value will be based upon the current index value at closing. Therefore, contracts for which the option legs of a spread or combination position have different settlement value terms will be recognized for margin purposes until the opening of trading two days prior to the expiration date. After that point spreads and combinations comprised of expiring FLEX Options and/or traditional index contracts will only be recognized for margin purposes if the contracts have the same settlement value terms.

Additionally, Regulation T and the Exchange's index margin rule (CBOE Rule 24.11) permit spreads and combinations between American and European exercise style options. Members should be aware that due to their different exercise features, pricing patterns may differ between European and American style index options. For instance, European style deep in-the-money put options have been observed trading at a discount to their intrinsic values. It is possible that the margin held by the carrying broker could become insufficient if a customer is long a European style option offset by a short American style option which is assigned and the customer is unable to exercise the long contract and liquidates the contract at a discount to its intrinsic value.

Capital Requirements

In general, FLEX Options will be treated as broad based index options for net capital purposes. However, due to the varying settlement terms noted above, offsets between FLEX contracts expiring on the same date but with different settlement value terms will be recognized for capital purposes until the close of business on the evening prior to expiration date. Positions maintained at the close of business on the evening prior to expiration will only be recognized as offsetting if the settlement value terms are identical.

Expiring FLEX contracts, with expiring settlement values based on terms other than the value of the index on the close of trading, will only be allowed to provide an offset to non-expiring FLEX contracts or to other traditional contracts until the close of business on the day preceding expiration of the near term Flex contract. After this point, the FLEX exercise/assignment value will be determined upon a basis other than the closing values of the index component stocks, and no haircut offset will be allowed.

Position Limits

The following are the Position Limits for FLEX Options:

FLEX Options shall be subject to position limits of an aggregate of 200,000 contracts on the same side of the market in any one FLEX Option index. FLEX Option positions shall not be aggregated with:

- Options on any stocks included in the index underlying the FLEX Options
- FLEX Option positions on another index
- Option contract positions in Non-FLEX options except:

Commencing at the close of trading 2 days prior to the last trading day before expiration, positions in P.M. Settled FLEX Options shall be aggregated with positions in QIX options on the same index and with the same last trading day before expiration (comparable QIX options). The aggregate positions shall be subject to the following limits:

(1) Aggregate positions in P.M. Settled FLEX Options and comparable QIX options on the S&P 100 shall be subject to a limit of 25,000 contracts on the same side of the market, provided that such positions shall be entitled to a hedge exemption from this limit under the terms and conditions and to the extent set forth in Interpretation and Policy .01 to Rule 24.4.

(2) Aggregate positions in P.M. Settled FLEX Options and comparable QIX options on the S&P 500 shall be subject to a limit of 45,000 contracts on the same side of the market, provided that such positions shall be entitled to one or more exemptions from this limit under the terms and conditions and to the extent set forth in Interpretation and Policy .02 to Rule 24.4. In no event, however, may more than 25,000 contracts be used for purposes of taking advantage of any differential in price between the S&P 500 index and the securities underlying the S&P 500.

Pursuant to Rule 4.13, members are required to report large options positions, manually via a form created by the Exchange (Form OE-10), on each business day following the establishment of long/short positions of option contracts of any single options class by an individual customer, customers acting in concert, the member firm, or any partner, officer or director of the member or of a group or syndicate account. The number of contracts which constitute reportable positions is 200 contracts on the same side of the market. Member firms may substitute an in- house computer report in lieu of the Exchange form. Member firms should not attempt to report such positions electronically via SIAC. Form OE-10 is available from the Department of Market Surveillance.

Exercise Limits and Advice Procedures

Exercise limits for FLEX options are the same as the position limits.

American Style Flex options are subject to the provisions of Exchange Rule 11.1 which requires that for all contracts exercised, an "exercise advice" must be delivered by the member or member organization in such form or manner prescribed by the Exchange to a place designated by the Exchange no later than 3:20 p.m. (CT) or a time designated to be five minutes after the close of trading. Please refer to Exchange Rule 11.1 and Regulatory Circular RG-92-02 for further details.

Membership Requirements

CBOE Rule 24A.13 requires market makers and floor brokers to be authorized to execute transactions in FLEX Options. In order to receive the authorization market makers and floor brokers must submit a completed application to the Membership Department. The application must be signed by an authorized person at the market maker's or floor broker's clearing firm before it is submitted to the Exchange. Market makers and floor brokers must maintain equity of at least $100,000 in their individual or joint accounts with any one clearing member in which transactions in FLEX Options will be conducted. Market makers whose equity falls below $100,000 are prohibited from effecting opening transactions in FLEX Options contracts. Floor brokers whose equity falls below $100,000, are prohibited from representing FLEX orders on the Exchange floor. Market makers and floor brokers must file with the Exchange one or more letters of guarantee (in the case of a market maker) and one or more letters of authorization (in the case of a floor broker) which have been issued by a clearing member, in which the clearing member assumes responsibility for the market makers or floor brokers FLEX transactions. An application may be obtained from the Membership Department.

For the requirements applicable to an Appointed Market Maker, please contact the Membership Department.

Questions concerning this memorandum or FLEX Options may be addressed to:

Trading Practices -- Barbara J. Casey - (312) 786-7712
Sales Practices -- Lawrence J. Bresnahan - (312) 786-7713
Margin and Capital -- Diane Malley - (312) 786-7924
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