

Regulatory Circular RG94-12

Date: February 4, 1994

To: The Membership

From: Department of Financial Compliance

Subject: Capital and Margin Requirements for NASDAQ-100 Index  
Options

On February 7, 1994 the Chicago Board Options Exchange ("CBOE") will begin to trade an option (symbol "NDX") composed of 100 non-financial securities in the NASDAQ National Market System. The NDX option will be broad-based and cash settled, with European-style exercise. The index is capitalization-weighted. This circular explains the margin and capital treatment applicable to transactions in NDX options.

MARGIN

NDX options are considered broad-based options for margin purposes and are subject to the margin requirements specified in CBOE Rule 24.11(b)(i). The margin requirement for a short put or call will be 100% of the option premium plus 15% 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. Pursuant to Regulation T Section 220.18 a long option position must be paid for in full. Spreads and straddles will be 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

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 offsetting transactions of NDX options market-makers in a) securities underlying the NDX index and b) options

overlying the National Over-the-Counter Index ("XOC")<sup>1</sup> 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. The SEC staff believes that the correlation between the NDX and XOC indexes is sufficient to allow for NDX market makers to effect offsetting transactions in XOC options subject to good faith margin treatment. If over time the correlations between the two indexes becomes less the SEC staff may amend its no-action position.

#### CAPITAL

For capital purposes, NDX options will be treated as broad-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.
- 10% 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.

Basket haircut treatment<sup>2</sup> will be available to NDX options and offsetting securities baskets. Additionally, offsetting positions in the NDX and XOC options can be haircut according to the cross-index methodology<sup>3</sup>, due to the high level of correlation between the two indexes.

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<sup>1</sup> XOC is an index option on the 100 largest securities in the NASDAQ National Market System trading at the Philadelphia Stock Exchange.

<sup>2</sup> 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 NDX basket offset by options is the greater of a) the haircut pursuant to paragraph (c)(2)(x) of SEC Rule 15c3-1, b) 5% of the value of the securities basket position or c) 45% of the amount by which the index is not offset by securities in the basket.

<sup>3</sup> See October 4, 1988 letter from Mary Bender of the CBOE to Michael Macchiaroli of the SEC.

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