

Regulatory Circular RG94-53

Date: July 21, 1994

To: The Membership

From: Department of Financial Compliance

Subject: Capital and Margin Requirements for CBOE Israeli  
Index Options

On July 27, 1994 the Chicago Board Options Exchange ("CBOE") will begin to trade an option (symbol "ISX") composed of fifteen (15) U.S. listed securities representing the Israeli economy. The ISX option will be narrow-based and cash settled, with European-style exercise. The index is price-weighted. This circular explains the margin and capital treatment applicable to transactions in ISX options.

MARGIN

ISX options are considered narrow-based options for margin purposes and are subject to the margin requirements specified in CBOE Rule 24.11(b)(ii). 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. 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 taken a no-action position allowing good faith credit to be extended to offsetting transactions of ISX options market-makers in securities underlying the ISX index 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, ISX options will be treated as narrow-based options. Under risk-based haircuts the haircut shall be equal to the maximum potential loss on the ISX portfolio calculated over a range of market movement of +(-) 15% of the underlying index value with a minimum charge of \$25 per contract in the portfolio.<sup>1</sup> As of July 27, 1994 not all market-maker clearing firms will be calculating market-maker haircuts pursuant to the risk-based methodology; although all clearing firms are expected to be operational on the new haircuts in the very near future. For those firms not utilizing risk based haircuts, the haircut on a short position calculated pursuant to the current methodology under SEC Rule 15c3-1 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.

Basket haircut treatment will be available to ISX options and offsetting securities baskets. The basket must represent 100% of the composition of the index. A 95% offset between the basket and the options will be applied with a minimum haircut equal to 5% of the aggregate underlying index value.

**Check with your clearing firm to determine the haircut methodology which will be used for your ISX positions as of July 27th.** Questions regarding the margin and capital treatment of ISX options should be directed to Diane Malley at (312) 786-7924 or Rich Lewandowski at (312) 786-7183.

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<sup>1</sup>Risk-based haircuts are applied pursuant to a SEC staff no-action letter dated March 15, 1994 from Brandon Becker, Director, SEC Division of Market Regulation, to Mary L. Bender, CBOE, and Timothy Hinkes, OCC.