

To: Membership

From: Department of Financial Compliance

Date: June 12, 1997

Re: Changes to CBOE Margin Rules – Market-Maker Permitted Offset Treatment

On June 2, 1997, the Securities and Exchange Commission (“SEC” or “Commission”) approved extensive changes to the CBOE’s margin rules.

*** * KEY ISSUES * ***

- Many of the changes involved conforming, to a large extent, CBOE’s margin rules to the margin rules of the New York Stock Exchange and otherwise, clarifying certain provisions of the current rule.
- More significantly, however, the SEC approved CBOE provisions governing permitted offset margin treatment for market-makers and specialists to replace provisions from Regulation T of the Federal Reserve Board which were deleted as of June 1, 1997. In addition, the new rules provide for an expansion in the types of permitted offsets.
- Specifically, the approved rule change extends market-maker margin credit to certain qualified stock baskets offsetting index options; to certain cross-index products contained in index product groups recognized by the SEC for haircut offsets; and to certain convertible securities offsetting equity options.
- To be eligible for the market-maker credit, offsets must be effected for market-making purposes such as hedging, risk reduction, rebalancing of positions, liquidation, or accommodation of customer orders, or other similar market-maker purpose.
- Clearing Firms must deduct from net capital any deficiency between a market-maker’s account equity and the haircuts for the account’s positions computed in accordance with Exchange Act Rule 15c3-1.
- CBOE clearing firms and other CBOE members that extend margin to market-makers are expected to implement adequate procedures to ensure that offsets elected by market-makers are recorded accurately and cleared into appropriate accounts.

Permitted Offset Positions

The first six permitted offset positions specified below codify the existing permitted offset positions that were provided under Regulation T until June 1, 1997. The last permitted offset position specified below permits good faith margin for offset positions defined in SEC Rule 15c3-1 and constitutes a significant expansion of permitted offset positions. Permitted offset transactions must be effected for market-making purposes such as hedging, risk reduction, rebalancing of positions, liquidation, or accommodation of customer orders, or other similar market-maker purpose.

Newly approved paragraph (f)(3) of Rule 12.3 defines a “permitted offset position” as, in the case of an option in which a market-maker makes a market, a position in the underlying instrument or other related instrument; and in the case of other securities in which a market-maker makes a market, a position in options overlying the securities in which a market-maker makes a market, if the account holds one of the following permitted offset positions:

- (i) A long position in the underlying instrument offset by a short option position which is “in or at the money:”
- (ii) A short position in the underlying instrument offset by a long option position which is “in or at the money”;
- (iii) A stock position resulting from the assignment of a market-maker short option position;
- (iv) A stock position resulting from the exercise of a market-maker long option position;
- (v) A net long position in a security (other than an option) in which a market-maker makes a market;
- (vi) A net short position in a security (other than an option) in which the market-maker makes a market; or
- (vii) An offset position as defined in SEC Rule 15c3-1, including its appendices, or any applicable SEC staff interpretation or no-action position.

For purposes of the Rule, the term “in- or at-the-money” means the current market price of the underlying security is not more than two standard exercise intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option; the term “in the money” means the current market price of the underlying instrument or index is not below (with respect to a call option) or above (with respect to a put option) the exercise price of the option; and, the term “overlying option” means a put option purchased or a call option written against a long position in an underlying instrument, or a call option purchased or a put option written against a short position in an underlying instrument.

Expanded Offsets

Market-maker credit may be extended to positions offsetting market-maker transactions to the extent that such offsets (i) are recognized as haircut offsets under SEC Rule 15c3-1, the Net Capital Rule, and (ii) are effected for a market-maker purpose as stated above. Additional offsets now recognized are as follows:

1. A security which is exchangeable for or convertible into the underlying security within a 90 day period,
2. A qualified stock basket, and

3. Dually-listed option classes, index options, UITs, or warrants where the underlying index is included in the same product group, as defined in SEC Rule 15c3-1 (or any applicable SEC interpretation or no-action position) as the option to be offset.

A product group is two or more option classes in the same portfolio type for which it has been determined that a high degree of correlation exists allowing for a percentage of offsetting profits in one class that may be applied to losses in another class. Currently the Net Capital Rule recognizes qualified baskets and product groups as indicated on the attached matrix.

For transactions qualified as permitted offsets, a clearing firm may call for equity deposits on a basis that is mutually satisfactory to the clearing firm and the market-maker account. However, as is currently the case, the clearing firm must deduct from its own net capital any deficiency in a market-maker's current equity as compared to the haircuts required for the account's positions, pursuant to SEC Rule 15c3-1 or any applicable SEC interpretations or no-action positions.

Questions and comments regarding the above may be directed to Richard Lewandowski, 786-7183, or to Diane Malley, 786-7924.