

Regulatory Circular RG97-126

Date: September 29, 1997
To: The Membership
From: Department of Financial Compliance
Subject: Capital and Margin Requirements for the Dow Jones Industrial Index Options

On October 6, 1997 the Chicago Board Options Exchange ("CBOE") will begin trading an index option based on the Dow Jones Industrial Average ("DOW"). The DOW Index is a broad based, price-weighted, cash-settled index with European-style exercise. The underlying index securities trade on the New York Stock Exchange. This circular explains the margin and capital treatment applicable to transactions in DOW options.

MARGIN

DOW 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 is 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 are 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.

CAPITAL

For capital purposes, DOW options will be treated as broad-based options. Under risk-based haircuts, the haircut is equal to the maximum potential loss for each index calculated over a range of market movements of +6%/-8% of the underlying index value for non-clearing market makers and +(-)10% for all other broker-dealers. Further, the DOW options will be included in the U.S.

Market Group A¹ and entitled to a 90% offset of gains on one index versus losses on another index at the same valuation point within the product group. For those firms not utilizing risk-based haircuts, the haircut will be calculated pursuant to the alternative strategy described in SEC Rule 15c3-1 Appendix A.

BASKET OFFSETS

Capital

Basket haircut treatment is available to DOW options and offsetting securities baskets. The basket must represent at least 50% of the DOW Index capitalization. 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.

Margin

Option Market Makers

As of June 2, 1997, CBOE rules permit option market makers to consider a qualified basket position as a permitted offset entitled to good faith margin. The basket must meet the capitalization requirements described above.

Non-Clearing Broker-Dealers and Customers

As of June 2, 1997, CBOE rules permit a qualified stock basket to serve as cover for a short index option. A qualified DOW basket will be comprised of all the underlying DOW securities in exact portion to the index. The short DOW option position will have no margin requirement. A long stock basket will be margined at 50%/25% of market value for initial/maintenance purposes. A short stock basket will be margin at 150%/130% of market value for initial/maintenance purposes.

Questions regarding the margin and capital treatment of DOW options should be directed to Doug Beck at (312) 786-7959 or Rich Lewandowski at (312) 786-7183.

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¹The U.S. Market Group A consist of the following indexes: Institutional Index (❧XII❧), Major Market Index (❧XMI❧), S&P 100 (❧OEX❧), S&P 500 (❧SPX❧), New York Stock Exchange Index (❧NYA❧), PHLX US Top 100 Index (❧TPX❧) and the Morgan Stanley Multinational Index (❧NFT❧).