

## **Regulatory Circular 98-144**

**To:           The Membership**

**From:       Department of Financial and Sales Practice Compliance**

**Date:        December 21, 1998**

**Subject:     Margin and Capital Requirements for Options on  
              the Dow Jones High-Yield Select 10 Index ("MUT")**

Options on the Dow Jones High-Yield Select 10 Index ("MUT") are targeted for listing and trading on the Chicago Board Options Exchange ("CBOE") in January 1999. The MUT is an equal-weighted index of the top 10 dividend-yielding stocks in the Dow Jones Industrial Average. The ten component stocks will be selected and re-balanced as an equal-weighted index on an annual basis. The MUT index base date will be December 31, 1998, when the index level will be set equal to the closing value of DJX. MUT options are cash settled and European style exercise.

The securities currently included in the index trade on the New York Stock Exchange. This circular explains the margin and capital treatment applicable to transactions in MUT options.

### **MARGIN**

In accordance with CBOE Rule 12.5, a long option position must be paid for in full.

The MUT index is considered narrow-based for margin purposes and option writers are subject to the margin requirements specified in CBOE Rule 24.11(b)(ii). The margin requirement for a short put or call on a narrow-based index is 100% of the option premium plus 20% of the underlying index value, less the out-of-the-money dollar amount, if any, subject to a minimum for calls of 100% of the premium plus 10% of the underlying index value, and a minimum for puts of 100% of the premium plus 10% of the exercise price.

In a margin account, no margin need be required in respect of a MUT call option carried in a short position which is covered by a long position in equivalent units of a "qualified stock basket" as defined in CBOE Rule 24.11(a)(2). Correspondingly, no margin need be required in respect of a MUT put option carried in a short position which is offset by a short position in equivalent units of a qualified stock basket. In computing margin on the

underlying qualified stock basket, the current market value used shall not be greater than the exercise price in the case of a short MUT call. In the case of a short MUT put, in computing margin on the underlying qualified stock basket, margin shall be the amount required by CBOE Rule 12.3(b)(2), plus any amount by which the exercise price of the put exceeds the current market value of the qualified stock basket.

Where a short option contract is covered by an “escrow agreement” meeting the requirements of CBOE Rule 24.11(d), no margin need be required on the short put or call.

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.

### OPTION MARKET-MAKER MARGIN REQUIREMENTS

Pursuant to CBOE Rule 12.3(f), market-makers in MUT are allowed “permitted offset” treatment for qualified stock baskets. In the case of the MUT index, the basket must contain no less than 95% of the capitalization in the index, in order to qualify as a permitted offset.

### CAPITAL

For capital purposes, MUT options are treated as narrow-based options. Under risk-based haircuts, the haircut is equal to the maximum potential loss for all MUT option positions calculated over a range of index movements of  $\pm 15\%$  for all broker-dealers, subject to a minimum charge of \$25 per contract.<sup>1</sup> A new product group will be established for MUT options. Currently MUT is the only component of that product group, therefore, no offsets with other products apply. For those firms not utilizing risk-based haircuts, the haircut will be calculated pursuant to SEC Rule 15c3-1a(b).

A basket offset is available to MUT options and offsetting qualified stock baskets under risk-based haircuts. The stock basket must represent not less than 95% of the capitalization of the index. A 95% offset between the qualified stock basket and the options will be applied with a minimum charge equal to 5% of the market value of the qualified basket.

Questions regarding the margin and capital treatment of MUT options should be directed to Jim Adams at (312) 786-7718 or Rich Lewandowski at (312) 786-7183.

### **Footnotes**

<sup>1</sup> Risk-based haircuts may be applied pursuant to SEC Rule 15c3-1a (Appendix A).