REGULATORY CIRCULAR RG99-09

Date: January 12, 1999

To: Members and Member Firms

From: Department of Financial and Sales Practice Compliance

Subject: Margin Accounts - Writing Index Options on a Covered Basis and Eligibility for Covered Writing Approval Level

PLEASE ROUTE TO: COMPLIANCE DEPARTMENT
OPTIONS DEPARTMENT
MARGIN DEPARTMENT
SENIOR REGISTERED OPTIONS PRINCIPAL
COMPLIANCE REGISTERED OPTIONS PRINICIPAL

KEY ISSUES

- In a margin account, SPX options and DJX options may be written on a covered basis against an equivalent offsetting position in SPDRS™ and DIAMONDS™, respectively.

- The writing of SPX options and DJX options in a cash account against an equivalent offsetting position in SPDRS and DIAMONDS, respectively, is not currently permitted.

- A firm can consider a customer margin account that is approved for “covered call writing” to also be approved for writing SPX and DJX calls on a covered basis provided the firm’s written procedures so specify.

- As a reminder, it is important to understand that due to the cash settlement feature of SPX and DJX options and the “timing risk” involved, there is an inherent limitation on the ability of writers of SPX and DJX options to cover their risk exposure by holding positions in SPDRS and DIAMONDS, respectively.

Based on regulatory approval[1], certain broad-based index options carried short **in a margin account** are eligible for status as "covered" positions if held in conjunction with an equivalent long position in respect of short call options, or an equivalent short position in respect of short puts, in a Unit Investment Trust ("UIT") or open-end mutual fund ("Fund") that has been specifically approved by the Exchange.

The Exchange has determined to recognize and approve the UITs listed below as acceptable offsets for the index options specified.

Exchange Approved Unit Investment Trust[2]	Corresponding Options
The SPDRS Trust	S&P 500™ index options ("SPX™")
The DIAMONDS Trust	Dow™ index options ("DJX™")

These UITs, while not deliverable upon exercise / assignment, will for margin purposes, be considered an underlying security for the corresponding index options. Currently, 1 SPX option contract is equivalent to 1,000 SPDRS units. One DJX contract is equivalent to 100 DIAMONDS units.

Therefore, in a margin account, no margin is required on an SPX or DJX call option carried short if it is offset, or "covered" by an equivalent long position in the corresponding, approved UIT. Similarly, no margin is required on an SPX or DJX put option carried short when it is offset, or "covered" by an equivalent short position in the corresponding approved UIT. In respect of short calls, the offsetting long position must be valued at current market value or the call exercise price, whichever is lower. In the case of short puts, any amount (aggregated) by which the exercise price of the put exceeds the current market value of the offsetting short position must be added to the short UIT (or Fund) margin requirement.

The requirements set-forth above apply to a short option position in a broad-based market index offset with a position in an equivalent UIT or Fund which replicates the same index, and has been approved by the Exchange. The writing

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[1] Letters regarding SPRRS dated Aug. 19, 1992, from James M. McNeil, American Stock Exchange, to Sharon Lawson, Securities and Exchange Commission; and January 14, 1993, from James McNeil to Laura Homer, Board of Governors of the Federal Reserve System ("FRB") and response letter dated Feb. 1, 1993, from Michael J. Shoenfeld, FRB, to James McNeil.

Letters regarding DIAMONDS dated December 3, 1997, from James McNeil, American Stock Exchange, to Scott Holz, FRB; and, Dec. 16, 1997, from Richard Lewandowski, Chicago Board Options Exchange, to Michael Walinskas, Securities and Exchange Commission.

[2] SPDRS and DIAMOND are listed on the American Stock Exchange. To date, the Exchange has not approved any open-end mutual funds.

of index call options on a covered basis in a cash account is under consideration, but is not currently permitted under Exchange Rules.

Risk Considerations

While short options on a broad-based market index offset with an equivalent position in a UIT or Fund that replicates the same index are treated as “covered” for margin purposes, the UIT or Fund **can not** be delivered (received) to meet an assignment obligation. Therefore short index options offset with equivalent UITs or Funds are not covered in the same sense as covered call or put writing on an individual stock. Exchange traded index options are cash settled. An assignment on a short index option results in a cash debit to an account for the in-the-money amount. The in-the-money amount is determined based upon an index value (the “exercise settlement value”) which is calculated at a set point in time. In respect of a short call option, the respective long UIT or Fund must be salable at a price equal to or greater than the exercise settlement value in order to properly offset the debit.[3] Following the point in time at which an exercise settlement value is determined and prior to the time at which an assignment notice is received for an in-the-money index call option that is carried short, the index, and consequently the value of the corresponding UIT or Fund, may decline. This “timing risk” is an inherent limitation on the ability of writers of cash settled index options to cover their risk exposure by holding positions in the underlying interest.

Options with an American style exercise feature (e.g., OEX) can be exercised on any business day. Options with a European style exercise feature (e.g., SPX, DJX) can be exercised only during the exercise period, which begins on the business day just prior to the expiration date. Thus, except for the day on which they become exerciseable, assignment risk is not as great a concern for European style options as it is with American style options.

Writers of index options are advised to review Chapter 10 - Principal Risks of Options Positions of the booklet Characteristics and Risks of Standardized Options (the options disclosure document) for an explanation of other risk factors.

Approved Strategy Level

For account approval purposes, margin accounts approved for covered call writing on individual stocks will be deemed by the Exchange as approved to write call options on a broad-based market index versus an equivalent position in a

[3] In the case of a short put option, the investor must be able to purchase the respective UIT for delivery against the short position at a price which is less than or equal to the exercise settlement value.

corresponding UIT[4] provided that a firm's written supervisory procedures specify that the covered equity call writing approval category encompasses approval for writing index call options on a covered basis against a UIT replicating the same index. A firm may also establish a dedicated approval item.

Pursuant to Exchange Rule 9.9, no member, Registered Options Principal or Registered Representative shall recommend to a customer the purchase or sale (writing) of any option contract unless the person making the recommendation has a reasonable basis for believing at the time of the recommendation that the customer has such knowledge and experience in financial matters that he/she may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

Questions regarding this Regulatory Circular should be directed to Jim Adams at (312) 786-7718.

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[4] The UIT (or open-end mutual fund) must be specifically approved by the Exchange.