Regulatory Circular RC99-65

To: **The Membership**

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

Date: **February 26, 1999**

Subject: **Margin and Capital Requirements for Options on the Dow Jones E*Commerce Index ("ECM")**

On February 26, 1999, the Chicago Board Options Exchange ("CBOE") listed and began trading options on the Dow Jones E*Commerce Index ("ECM"). The ECM is a modified capitalization weighted index of 15 of the largest, most liquid U.S. Internet commerce stocks; that is, companies involved in providing a good or service through an open network such as the Internet. The index will be rebalanced after the close of trading on expiration Friday on the March quarterly cycle. The base date for the ECM index is January 4, 1999, when the index level was calculated at 200.00 at the close of trading. ECM options are cash settled and European style exercise.

The securities currently included in the index trade on the National Association of Securities Dealers Automated Quotation System ("NASDAQ"). This circular explains the margin and capital treatment applicable to transactions in ECM options.

<u>MARGIN</u>

In accordance with CBOE Rule 12.3(c)(4), a long option position must be paid for in full.

The ECM 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 current market value of the contract 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 option market value plus 10% of the underlying index value, and a minimum for puts of 100% of the option market value plus 10% of the option's aggregate exercise price.

In a margin account, no margin need be required in respect of an ECM 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 ECM 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 ECM call. In the case of a short ECM 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 ECM are allowed “permitted offset” treatment for qualified stock baskets. In the case of the ECM 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, ECM index options are treated as narrow–based. Under risk–based haircuts, the haircut is equal to the maximum potential loss for all ECM option positions calculated over a range of index movements of +(–)15% for all broker–dealers, subject to a minimum charge of $25 per contract.[1] A new product group will be established to include ECM options, TheStreet.com Internet Commerce Index (“ICX”) listed on the American Stock Exchange and the TheStreet.com Internet Sector Index (“DOT”) listed on the Philadelphia Stock Exchange. A 75% offset of gains versus losses at the same valuation point will be allowed between each index class within the product group. 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 ECM 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 ECM options should be directed to Jim Adams at (312) 786–7718 or Rich Lewandowski at (312) 786–7183.

Footnotes

[1] Risk–based haircuts may be applied pursuant to SEC Rule 15c3-1a (Appendix A).