Regulatory Circular RG10-110

To: **Trading Permit Holders (TPH)**

From: **Regulatory Services Division**

Date: **October 27, 2010**

Re: **Delta Position Limit Hedge Exemption**

This Regulatory Circular provides guidance on delta hedge exemption for position limit purposes. The Regulatory Division is re-issuing this Circular, which includes various updates, to provide guidance to TPHs that wish to utilize the delta hedge exemption.

Frequently Asked Questions

1. What is a delta hedge exemption?

The delta hedge exemption allows an eligible TPH or non-TPH affiliate of a TPH to apply a delta to an equity option position to calculate its overall net position for position limit purposes. This is an additional hedge exemption to the approved exemptions listed in CBOE Rule 4.11.04.

2. Who is eligible to use the delta hedge exemption?

A TPH or non-TPH broker-dealer and certain other financial institutions that use a "permitted pricing model" as defined in CBOE Rule 4.11 are eligible to use the exemption.

In support of the delta position limit effort, the Options Clearing Corporation ("OCC") will provide subscribers with an OCC generated delta value for each option series.

Customer accounts are not eligible to apply the delta hedge exemption (see: Regulatory Circular RG 09-103).

3. When will the delta hedge exemption become effective?

The delta hedge exemption became effective on February 1, 2008.[1]

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[1] On May 27, 2010, the delta hedge exemption was expanded to include correlated securities.

4. What do I need to do to apply the delta hedge exemption?

An entity that is eligible to rely on the delta hedge exemption must **first** provide the CBOE with a written certification that the entity uses a "permitted pricing model" and is therefore eligible to apply this exemption.

A TPH carrying an account of a non-TPH affiliate that intends to rely on this exemption must first obtain from such non-TPH:

1. A written certification to the CBOE that it is using a "permitted pricing model" and is therefore eligible to apply this exemption; and,
2. A written statement confirming that the non-TPH affiliate:
   - is relying on this exemption;
   - will use only a permitted pricing model for purposes of net delta calculations;
   - will promptly notify the TPH if it ceases to rely on this exemption;
   - authorizes the TPH to provide information to the CBOE or the OCC;
   - if using the OCC pricing model, has duly executed and delivered to CBOE such documents as the CBOE may require as a condition for reliance on the exemption.

At this time the CBOE expects that TPHs and/or non-TPH affiliates electing to use the delta hedge exemption will inform the CBOE of the specific account or entity identifying information that it intends to use to satisfy the reporting obligations of the exemption.

Other options exchanges and the Financial Industry Regulatory Authority ("FINRA") include position limits, including the use of the delta hedge exemption, in a coordinated regulatory program pursuant to the "17d-2 arrangement."[2] Common members of the 17d-2 participants are allocated to one of the regulatory participants. After notification of such assignment, the common member will provide any such written certification to its assigned regulator.

5. Does the delta hedge exemption apply to the firm's overall position or can the firm use this exemption for specific accounts?

A firm can apply the delta hedge exemption either to its entire position in a particular security or to the positions in a particular security held by one or more of its' **approved** "aggregation units." Within each aggregation unit there can be several trading units, as described in CBOE Rule 4.11. (See bullet 9 for additional information on trading units)

In order for an "aggregation unit" to be approved, the firm must submit a written request to the Regulatory Division of the CBOE or to the TPH's assigned regulator, as applicable (see bullet 4 above) describing the aggregation units (reporting structure within each aggregation unit and the control aspects of the management for each unit citing any overlaps in responsibilities). This should be followed with an explanation as to why the unit should be separated from the

[2] The NYSE Amex LLC (AMEX); BATS Exchange, Inc. (BATS); C2 Options Exchange, Inc. (C2); the Chicago Board Options Exchange, Inc. (CBOE); the International Securities Exchange LLC (ISE); Financial Industry Regulatory Authority, Inc. (FINRA); NYSE Arca, Inc. (ARCA); NASDAQ OMX BX, Inc. (BX); and NASDAQ OMX PHLX, Inc. (PHLX), participate in an arrangement for allocation of regulatory responsibility pursuant to SEC Rule 17d-2.

rest of the firm for position limit purposes. The request must satisfy the provisions of CBOE Regulatory Circular RG08-12 (previously RG04-45).

6. What is an "Option Contract Equivalent of the Net Delta (OCEND)?"

The OCEND is an aggregate position number adjusted for a series delta and is subject to the appropriate position limit, and is calculated by taking the net delta divided by the number of shares that equate to one option contract on a delta basis.

The OCEND should be submitted using the same specific account or entity identifying information that the firm provided to CBOE upon notice of intent to elect the delta hedge exemption.

7. What are the reporting requirements if the delta hedge exemption is applied to the firm's entire position in a particular security (no separate aggregation units)?

A) For OCC members, the requirement is:

> Report the OCEND to the OCC through the "Delta Based Position Limit Aggregator Report" when the firm's equity option position in a particular security exceeds the position limit on a contract basis.

B) For non-OCC members, the requirements are:

- i) Report the OCEND to the OCC through the "Delta Based Position Limit Aggregator Report" when the firm's equity option position in a particular security exceeds the position limit on a contract basis.
- ii) Report to the Large Option Position Report ("LOPR") when a position is greater than or equal to 200 contracts on the same side of the market (no change to the current reporting requirements). The LOPR should also be submitted using the same specific account or entity identifying information that it provided to CBOE upon notice of intent to elect the delta exemption.

8. What are the reporting requirements if a firm wants to apply the delta hedge exemption to different aggregation units?

For OCC and non-OCC members, the requirements are:

A) Report the OCEND to the OCC through the "Delta Based Position Limit Aggregator Report" when the aggregation unit's equity option position in a particular security exceeds the position limit on a contract basis.

B) Report to the LOPR when a position is greater than or equal to 200 contracts on the same side of the market for each aggregation unit.

C) The account or entity identifying information on these reports should be consistent with the specific account or entity identifying information provided to CBOE upon notice of intent to elect the delta hedge exemption.

9. What should I report if an aggregation unit has one or more trading units that do not use the delta hedge exemption?

The entity must combine the OCEND of the trading units using the delta hedge exemption with the positions on a contract basis of the trading units not using the exemption.

For example, if Aggregation Unit A has an OCEND of long 200,000 deltas, and a trading unit within Aggregation Unit A that is not using delta is long 60,000 contracts (unhedged) and short 20,000 contracts, the firm should report 260,000 deltas to the "Delta Based Position Limit Aggregator Report." Since the trading unit is not using delta, the firm may not net the 260,000 contract equivalent long position with the 20,000 contract short position to lessen the net deltas reported.

10. Is there a technical document that describes how to submit the OCEND to the "Delta Based Position Limit Aggregator Report?"

The OCC has published a user guide that provides technical specifications on how to submit position information to the "Delta Based Position Limit Aggregator Report."

http://www.optionsclearing.com/clearing/industry-services/delta-position-limits.jsp

Failure to report the OCEND may result in regulatory action.

11. Does the Delta Hedge Exemption apply both to standardized and conventional options?

Yes, the delta hedge exemption applies to standardized and conventional options separately. For example, IBM options would have a 250,000 contract position limit in the standardized options and, under NASD rules, a separate 250,000 contract position limit in the conventional options.

12. Does the Delta Hedge Exemption apply to correlated securities other than the underlying?

Yes, the delta hedge exemption applies to correlated securities. This exemption allows ETFs to be hedged with their underlying index. Some examples include: SPDRs (SPY) and the S&P 500 Index (SPX), iShares Russell 2000 Index (IWM) and the Russell 2000 Index (RUT), and Powershares QQQ (QQQQ) and the Nasdaq 100 Index (NDX) (See Exchange Rule 24.4 Interpretations and Policies .05).

Any questions regarding the CBOE delta position limit hedge exemption may be directed to the Department of Market Regulation at (312) 786-7730.

Replaces Regulatory Circular RG08-18