

Regulatory Circular RG15-183

Date: December 16, 2015

To: Trading Permit Holders and Clearing Trading Permit Holders
From: Regulatory Division
RE: Covered Margin Treatment for Short, Cash-Settled Index Options

KEY POINTS

- On November 18, 2015, the Securities and Exchange Commission approved a customer strategy-based margin rule proposal by the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) that allows a short position in a cash-settled-index option that is established and carried **in a margin account** to receive covered margin treatment, if the short option position is offset in the same account by an equivalent position in an index tracking Exchange Traded Fund (“ETF”) that is based on the same index that underlies the short option(s).¹
- The rule change was effective upon approval.
- Previously, the Exchange issued Regulatory Circulars that provided for covered margin treatment for a number of short, cash-settled index options offset by an equivalent position in a specific index tracking ETF.² Generally, Regulatory Circulars will no longer be issued.
- Clearing Trading Permit Holders (TPHs) are responsible for ensuring that there is a sufficient number of ETF shares held to cover a short index option position (i.e., for testing whether the value of the ETF position is at least equivalent to the current aggregate index value of the index option being covered). It should be noted that not all ETFs are managed so as to maintain a share price that is a constant fraction (e.g., 1/10 th, 1/100 th, 1/1,000 th, etc.) of the index being tracked. In the case of such ETFs, it is especially important that Clearing TPHs employ a computational process.

DISCUSSION

The Securities and Exchange Commission has approved a rule proposal by the CBOE which, in a margin account, permits cash-settled index options to be written on a “covered” basis for margin purposes against an equivalent offsetting position in an index tracking ETF that is based on the same index underlying the option(s) written.¹ The rule became effective upon approval. The rule permits this treatment only in margin accounts.

¹ See Securities Exchange Act Release No. 34-76469 (November 18, 2015), 80 FR 73252 (November 24, 2015) (SR-CBOE-2015-077). Also, see CBOE Rule 12.3(c)(5)(C)(2).

² See Regulatory Circulars **RG99–09** (permitting SPDRS and DIAMONDS to cover short S&P 500 Index option (“SPX”) positions and Dow Jones Industrial Average Index option (“DJX”) positions, respectively); **RG00–171** (permitting the iShares S&P 100 Index Fund to cover short S&P 100 Index option (“OEX”) positions); **RG01–119** (permitting NASDAQ-100 Index Tracking Shares to cover short NASDAQ-100 Index option (“NDX”) or Mini-NASDAQ-100 Index option (“MNX”) positions); **RG02–110** (permitting the iShares S&P 500 Fund to cover short SPX option positions); **RG07–126** (permitting the iShares Russell 2000 Index Fund to cover short Russell 2000 Index option (“RUT”) positions); and **RG12–127** (permitting the Vanguard S&P 500 ETF and Vanguard Russell 2000 ETF to cover short SPX and RUT option positions, respectively).

In order to receive covered margin treatment, the market value of the offsetting ETF position must be equivalent to the current aggregate index value of the option being covered. For example, given an index with a current level of 1800.00 and a cash-settled option on that index with a multiplier of \$100, the current aggregate index value underlying the option is \$180,000.00 (1,800 x \$100). In order to receive covered margin treatment, an offsetting ETF with a market value of \$180,000.00 would be required. Note that not all ETFs are managed so as to maintain a share price that is a constant fraction (e.g., 1/10 th, 1/100 th, 1/1,000 th, etc.) of the index being tracked. Clearing TPHs are responsible for ensuring that there is a sufficient number of index tracking ETF shares held to cover a short index option position (i.e., for testing whether the value of the ETF position is at least equivalent to the current aggregate index value of the index option being covered). In the case of ETFs that do not maintain a share price that is a constant fraction of the index being tracked, it is important for Clearing TPHs to employ a computational process to ensure equivalency.

Therefore, in a margin account, no margin is required on a cash-settled index call option carried short that is offset, or "covered," in the same account by an equivalent long position in an index tracking ETF that is based on the same index underlying the short option(s). Similarly, no margin is required on a cash-settled index put option carried short that is offset, or "covered," in the same account by an equivalent short position in an index tracking ETF that is based on the same index underlying the short option(s).

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 margin requirement on the offsetting short position.

Risk Considerations

While short options on a market index offset with an equivalent position in an ETF or open-end mutual fund ("Funds") that replicate the same index may be treated as "covered" for margin purposes, the Funds cannot be delivered (received) to meet an assignment obligation. Therefore, short index options offset with equivalent positions in the Funds are not covered in the same sense as the writing of a covered call or put 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 Fund, or portion thereof, 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 a short, in-the-money index call option, the market price of the corresponding 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 at any time prior to their expiration. Options with a European-style exercise feature, such as S&P 500 index options and Russell 2000 index options, can be exercised only during the exercise period, which is generally the expiration date. Thus, except for the day on which they become exercisable, assignment risk is not as great a concern for European-style options as it is with American-style options.

Additional Information:

Questions regarding this Regulatory Circular should be directed to CBOE's Regulatory Interpretations and Guidance team at (312) 786-8141 or reginterps@cboe.com.

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