

## Regulatory Circular RG99-160

Date: August 13, 1999  
To: Members and Member Firms  
From: Department of Financial and Sales Practice Compliance  
Subject: Securities and Exchange Commission  
Approval of Expanded Margin Rules (Rule 12.3)

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PLEASE ROUTE TO: COMPLIANCE DEPARTMENT  
OPTIONS DEPARTMENT  
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SENIOR REGISTERED OPTIONS PRINCIPAL  
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### KEY ISSUES

- April 1996 amendments to Regulation T of the Board of Governors of the Federal Reserve System delegated authority to option exchanges to set option margin requirements in their rules, provided such rules are approved by the Securities and Exchange Commission ("SEC").
- The Exchange filed an extensive margin rule change proposal with the SEC on December 29, 1997 (SR-CBOE-97-67<sup>1</sup>), containing a number of strategy-based enhancements and new capabilities.
- The provisions contained in SR-CBOE-97-67 were recommendations of an industry committee<sup>2</sup> comprised of the options self-regulatory organizations and representatives from a number of member firms, and the Committee's recommendations represent an industry consensus.
- On July 27, 1999, the Securities and Exchange Commission approved SR-CBOE-97-67. The new provisions will become effective on Monday, August 23, 1999.

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<sup>1</sup> See SEC Release No. 34-39925 (63 FR 24580). Comparable rules were filed by the New York Stock Exchange ("NYSE") on January 27, 1999 (SR-NYSE-99-03). See SEC Release No. 34-41168 (64 FR 13630). The NYSE's comparable filing (SR-NYSE-99-03) is expected to be approved imminently.

<sup>2</sup> An Options Sub-committee of the NYSE's Rule 431 Review Committee. (Rule 431 sets forth the NYSE's margin requirements.)

- The new provisions implemented through SR-CBOE-97-67 represent the second phase of the Exchange's efforts to upgrade margin rules under the authority granted by amendments to Regulation T.
- Exchange staff is currently working on a third phase which is a risk-based (portfolio) margin and cross margin approach, as an alternative to strategy-based margin requirements for broad-based index products. A risk-based margin and cross-margin capability is being sought primarily for affiliates of clearing member firms, professional futures traders, and sophisticated, high net worth customers such as institutions. A pilot program is now being devised, and operation is projected to begin in the second quarter of 2000.

**New provisions concerning margin account  
initial and maintenance requirements are as follows:**

Loan Value for Long-Term Listed Options. Member firms may now lend up to 25% of the current market value of a listed option that has more than 9 months until expiration. Thus, the initial (and maintenance) margin requirement is 75%. It should be noted that at the point in time a margined option has 9 months until expiration, the option will no longer have market value for margin purposes, and there will be a decrease in margin account equity equal to the option's market value at that time. This could lead to a maintenance margin call if there is little or no maintenance margin excess in the account.

Loan Value for Long-Term OTC Options. Member firms may now lend up to 25% of the **in-the-money** amount (or intrinsic value) of an OTC option that has more than 9 months until expiration provided the OTC option is guaranteed by the member firm and has an American style expiration. Thus, the initial (and maintenance) margin requirement is 75% of intrinsic value plus 100% of any amount by which the current market value of the option exceeds the intrinsic value. As with a listed option, the current market value of a margined OTC option must also be excluded from account equity at the point in time the option has 9 months until expiration.

Long (Debit) Butterfly Spreads. The net debit incurred by establishing a long butterfly spread (the max. risk) must be paid for in full. The butterfly spread must be structured as defined in the rule. (Previously, margin was required on the credit spread component, treating each of the two spread components as separate and distinct.)

Short (Credit) Butterfly Spreads. For short call butterfly spreads, the difference between the two lowest exercise prices (aggregate); and for short put butterfly spreads, the difference between the two highest exercise prices (aggregate). Net credit received may be applied. The butterfly spread must be structured as defined in the rule. (Previously, margin was required on the credit spread component, which is the same as the current requirement. Thus, there is no change in total margin required, only a change to identify a butterfly spread.)

Long (Debit) Box Spreads. The net debit incurred by establishing a long box spread (the max. risk) must be paid for in full. The box spread must be structured as defined in the rule.

Short (Credit) Box Spread. The difference in the exercise prices (aggregate). Net credit received may be applied. The box spread must be structured as defined in the rule.

Loan Value for Long Box Spreads in European Style Options. (Each Option Component Must be Listed or, in the case of an OTC option, Guaranteed by the Carrying Member Firm.) Member firms may lend up to 50% of the difference in the exercise prices (aggregate) if a box spread is comprised of European style options. For margin purposes, the long box must be valued at an amount not to exceed 100% of the difference in the exercise prices (aggregate).

[e.g., if a 10 point long box spread is established for a net debit of  $9\frac{1}{2}$ , the member firm may lend \$5 ( $50\% \times 10$  points) and the remainder,  $\$4\frac{1}{2}$  ( $9\frac{1}{2} - 5$ ), must be paid for in full.] The box spread must be structured as defined in the rule.

**New provisions concerning margin account maintenance requirements on certain stock positions (underlying component) are as follows:**

Long Put / Long Stock Hedge. The lower of: 1) 10% of the put exercise price (aggregate) plus 100% of any out-of-the-money amount, or 2) 25% of the stock current market value.

Long Call / Short Stock Hedge. The lower of: 1) 10% of the call exercise price (aggregate) plus 100% of any out-of-the-money amount, or 2) 30% of the stock current market value.

Long Stock / Long Put / Short Call (Conversion). 10% of the exercise price. Put and call must have the same exercise price and time of expiration.

Short Stock/ Long Call / Short Put (Reverse Conversion). 10% of the exercise price. Put and call must have the same exercise price and time of expiration.

Long Stock / Long Put / Short Call (Collar). The lower of: 1) 10% of the put exercise price (aggregate) plus 100% of any put out-of-the-money amount, or 2) 25% of the call exercise price (aggregate). Put and call must have different exercise prices and the same time of expiration.

**New provisions concerning spreads in a cash account.**

**The below-listed spread strategies, if structured as defined in Rule 12.3, are now permitted in a cash account provided the component options are all 1) cash-settled, 2) European style exercise, and 3) have the same time of expiration.**

<b>DEBIT SPREADS</b>	<b>REQUIREMENT</b>
Long Call Spreads Long Put Spreads Long Call Butterfly Spreads Long Put Butterfly Spreads Long Box Spreads	pay for net debit in full
<b>CREDIT SPREADS</b>	<b>REQUIREMENT</b>
Short Call Spreads Short Put Spreads Short Box Spreads	deposit cash or cash equivalents equal to exercise price differential; net credit received may be applied
Short Call Butterfly Spreads	deposit cash or cash equivalents equal to the differential between the two lowest exercise prices; net credit received may be applied
Short Put Butterfly Spreads	deposit cash or cash equivalents equal to the differential between the two highest exercise prices; net credit received may be applied

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Escrow Agreement for Cash Account Spread Requirements. A new rule will permit an escrow agreement representing cash or cash equivalents held at a bank to be deposited in a cash account to meet the requirements on short (credit) spreads.

Consolidation of Margin Rules From Various Chapters. Margin rules that were contained in Chapters 23 (Interest Rate Options), 24 (Index Options) and 30 (Trading in Stocks, Warrants and Other Securities) have been consolidated under Chapter 12.

Questions regarding this Regulatory Circular, and margin rules in general, may be directed to Jim Adams - (312) 786-7718 or Rich Lewandowski - (312) 786-7183 in the Department of Financial and Sales Practice Compliance.