

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-48115; File No. SR-CBOE-2003-24)

July 1, 2003

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 thereto by the Chicago Board Options Exchange, Incorporated to Interpret Rules Relating to Margin Requirements for Certain Complex Options Spreads on a Pilot Basis

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 8, 2003, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On June 26, 2003, the CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to issue a Regulatory Circular to its membership setting forth a clarifying interpretation to CBOE Rule 12.3, Margin Requirements, relating to margin requirements for certain complex option spreads. Below is the text of the proposed Regulatory Circular. Additions are italicized.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 provides that the Regulatory Circular will be in effect as a one-year pilot from the date of approval of the proposed rule change.

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To: Member Organizations

From: Division of Regulatory Services

Date: \_\_\_\_\_, 2003

Subject: Margin Requirements for Certain Complex Spreads

Exchange James Adams (312) 786-7718

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KEY POINTS

- Certain complex option spreads (specified below) are the equivalent of combining two or more spreads that are currently recognized in the margin rules of the Chicago Board Options Exchange (the “Exchange” or “CBOE”).
- Because these complex spreads can be shown to equate to aggregations of two or more currently recognized spreads, current margin rules are deemed to provide a margin requirement for each complex spread in that the rules provide a margin requirement for each spread in the equivalent aggregation.
- Member organizations may require margin for these complex spreads of not less than the sum of the margin required on each spread in the equivalent aggregation.
- The margin requirements set forth in this Regulatory Circular will be in effect as a pilot until {Insert date that is one (1) year from the date of approval of the Regulatory Circular by the Commission}.

## DISCUSSION

It is known that certain complex spread configurations are the net result of combining two or more spread strategies that are currently recognized in the Exchange's margin rules. Specific complex spread configurations are listed below, along with the currently recognized spreads to which they can be traced. The expiration months, exercise prices, interval between exercise prices, and option premiums used in each configuration are for illustration only. However, as illustrated, the expiration months and sequence of the exercise prices must fit the same pattern, and the intervals between the exercise prices must be equal. Note that netting of contracts in option series common to each of the currently recognized spreads in an aggregation reduces it to the complex spread.

	<u>Feb 45</u> <u>@ .5</u>	<u>Feb 50</u> <u>@ 1</u>	<u>Feb 55</u> <u>@ 2</u>	<u>Feb 45</u> <u>@ 16.5</u>	<u>Feb 50</u> <u>@ 12</u>	<u>Feb 55</u> <u>@ 8</u>	<u>Feb 60</u> <u>@ 6</u>	<u>Feb 65</u> <u>@ 5</u>	<u>Apr 60</u> <u>@ 7</u>
<u>Long Butterfly</u>					1	-2	1		
<u>Long Butterfly</u>						1	-2	1	
<u>Net - Configuration I</u>					<u>1</u>	<u>-1</u>	<u>-1</u>	<u>1</u>	
<u>Long Butterfly</u>					1	-2	1		
<u>Short Box</u>		1	-1		-1	1			
<u>Net - Configuration II</u>		<u>1</u>	<u>-1</u>		<u>-1</u>	<u>1</u>			
<u>Long Butterfly</u>					1	-2	1		
<u>Long Butterfly</u>						1	-2	1	
<u>Short Box</u>		1	-1		-1	1			
<u>Net - Configuration III</u>		<u>1</u>	<u>-1</u>				<u>-1</u>	<u>1</u>	
<u>Long Time Spread</u>							-1		1
<u>Long Butterfly</u>					1	-2	1		
<u>Net - Configuration IV</u>					<u>1</u>	<u>-2</u>			<u>1</u>
<u>Long Time Spread</u>							-1		1
<u>Long Butterfly</u>					1	-2	1		
<u>Long Butterfly</u>				1	-2	1			
<u>Net - Configuration V</u>				<u>1</u>	<u>-1</u>	<u>-1</u>			<u>1</u>
<u>Long Time Spread</u>							-1		1
<u>Long Butterfly</u>					1	-2	1		
<u>Short Box</u>		1	-1		-1	1			
<u>Net - Configuration VI</u>		<u>1</u>	<u>-1</u>			<u>-1</u>			<u>1</u>
<u>Long Time Spread</u>							-1		1
<u>Long Butterfly</u>					1	-2	1		
<u>Long Butterfly</u>				1	-2	1			
<u>Short Box</u>		1	-1	-1	1				
<u>Net - Configuration VII</u>	<u>1</u>	<u>-1</u>		<u>-1</u>	<u>1</u>	<u>-1</u>			<u>1</u>

As illustrated above, the complex spread configurations equate to aggregations of currently recognized spreads. Therefore, for complex spreads fitting the above configurations, whether established outright or through netting, member firms must require initial and maintenance margin of not less than the sum of the margin required on each of the currently recognized spreads in the applicable aggregation subject to the following limitations:

- the complex spread must be carried in a margin account.

- European style options are not permitted for the configurations involving time spreads (IV through VII).
- the intervals between exercise prices must be equal, and
- each complex spread must comprise four option series, except for Configuration IV, which must comprise three option series.

Summing the margin required on each currently recognized spread in each of the applicable aggregations renders a margin requirement for the subject complex spread configurations as follows:

<u>Configuration</u>	<u>Margin Requirement</u>
<u>I</u>	<u>Pay for the net debit in full</u>
<u>II</u>	<u>Exercise price interval (aggregate), net credit may be applied</u>
<u>III</u>	<u>Exercise price interval (aggregate), net credit may be applied</u>
<u>IV</u>	<u>Pay for the net debit in full</u>
<u>V</u>	<u>Pay for the net debit in full</u>
<u>VI</u>	<u>Exercise price interval (aggregate), net credit may be applied</u>
<u>VII</u>	<u>Exercise price interval (aggregate), net credit may be applied</u>

Using Configuration III as an example, the margin requirement and SMA debit or margin call would be as follows:

	<b>PUTS</b>		<b>CALLS</b>			
	<u>Feb 50</u>	<u>Feb 55</u>	<u>Feb 50</u>	<u>Feb 55</u>	<u>Feb 60</u>	<u>Feb 65</u>
	<u>@ 1</u>	<u>@ 2</u>	<u>@ 12</u>	<u>@ 8</u>	<u>@ 6</u>	<u>@ 5</u>
<u>Long Butterfly #1</u>			<u>1</u>	<u>-2</u>	<u>1</u>	
<u>Long Butterfly #2</u>				<u>1</u>	<u>-2</u>	<u>1</u>
<u>Short Box #1</u>	<u>1</u>	<u>-1</u>	<u>-1</u>	<u>1</u>		
<b><u>Net – Configuration III</u></b>	<b><u>1</u></b>	<b><u>-1</u></b>			<b><u>-1</u></b>	<b><u>1</u></b>

Margin Calculation: \$5.00 x 1 contract x 100 shares = \$500.00

Margin Requirement: \$500.00

SMA Debit or Margin Call: \$500.00 - \$200.00 = \$300.00

Explanation: The initial and maintenance margin requirement is the exercise price

interval (aggregate). Establishing this complex spread results in a net credit of \$200.00 that may be applied to the margin requirement.

As shown in the table below, the same margin requirement, and SMA debit or margin call, would result by taking the sum of the margin required on each spread in the equivalent aggregation.

	<u>Net dr or cr</u>	<u>Margin Req.</u>	<u>Deposit</u>
<u>Long Butterfly</u>	<u>\$200 dr</u>	<u>0</u>	<u>\$200</u>
<u>Long Butterfly</u>	<u>\$100 dr</u>	<u>0</u>	<u>\$100</u>
<u>Short Box #1</u>	<u>\$500 cr</u>	<u>\$500</u>	<u>\$0</u>
<u>Total</u>	<u>\$200 cr</u>	<u>\$500</u>	<u>\$300</u>

The margin requirements set forth in this Regulatory Circular will be in effect as a pilot until {insert date one (1) year from the date of approval of the Regulatory Circular by the Commission}.

Questions regarding margin requirements should be directed to James Adams at (312) 786–7718 or Richard Lewandowski at (312) 786–7183.

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II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to adopt an interpretation to CBOE Rule 12.3 - Margin Requirements – to clarify that margin requirements for certain complex option spreads are provided for under CBOE Rule 12.3. The Exchange proposes to implement this interpretation through a Regulatory Circular that will set forth the margin requirements for such complex spreads. The Exchange believes that the complex spreads in question are simply another way of expressing a collection of two or more basic option spreads (*i.e.*, the butterfly spread, the box spread, and the time spread) already covered under the margin rules. Therefore, the Exchange believes that the complex spread margin requirements are reasonably implied by, and are a logical extension of, the current margin rules. The proposed Regulatory Circular is intended to be a temporary measure and will operate as a pilot for one year from the date of approval of the Regulatory Circular by the Commission.

The proposed Regulatory Circular identifies seven complex spread configurations, each of which can be shown to equate, on a risk/reward basis, to a package of two or more basic spread strategies that are already identified and ascribed a margin requirement under the Exchange's current margin rules. According to the Exchange, netting the common option series between the basic spreads in the package corresponding to a complex spread actually results in the complex spread. Therefore, the Exchange believes that a complex spread can be viewed as the sum of two or more basic spreads. The Exchange believes further that for each complex spread configuration identified in the proposed Regulatory Circular, the sum of the margin required on the basic spreads in an equivalent package covers the maximum risk of the complex spread, and is an appropriate minimum requirement.

The proposed Regulatory Circular holds that a margin requirement for each of the seven complex spread configurations identified is, in effect, provided for under current CBOE margin rules because they equate to basic spread strategies for which margin requirements are already specified. Therefore, according to the Exchange, the proposed Regulatory Circular will allow member organizations to require margin for the subject complex spreads, whether established outright or through netting, of not less than the sum of the margin required on each basic spread in its corresponding package.

To be eligible for the margin requirements set forth in the proposed Regulatory Circular, a complex spread must match one of the seven patterns specified in the proposed Regulatory Circular. Furthermore, the proposed Regulatory Circular mandates that: 1) complex spreads must be carried in a margin account; 2) European-style options are prohibited for complex spread configurations having a long option series that expires after the other option series (i.e., involves a time spread); 3) the intervals between exercise prices of each option series must be equal; and 4) each complex spread must comprise four option series, with the exception of one configuration, which must comprise three option series. In view of these limitations, the Exchange believes the complex spread margin requirements are non-controversial.

## 2. Statutory Basis

The Exchange believes that the proposed Regulatory Circular clarifies that the Exchange's current margin rules extend to complex option spreads, thereby, allowing investors to more efficiently implement these strategies. As such, the Exchange believes that the proposed Regulatory Circular interpretation of CBOE Rule 12.3 is consistent with and furthers the



objectives of Section 6(b)(5) of the Act,<sup>4</sup> in that it is designed to perfect the mechanisms of a free and open market and to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The CBOE does not believe that the proposed Regulatory Circular interpretation of CBOE Rule 12.3 will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

No written comments were solicited or received with respect to the proposed Regulatory Circular interpretation of CBOE Rule 12.3.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- A. by order approve such proposed rule change; or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act.

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<sup>4</sup> 15 U.S.C. 78f(b)(5).

Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to file number SR-CBOE-2003-24 and should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>5</sup> 17 CFR 200.30-3(a)(12).