Regulatory Circular RG99-107

To: **The Membership**

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

Date: **April 16, 1999**

Subject: **Margin and Capital Requirements for Options on the Dow Jones Equity Real Estate Investment Trust Index ("DJR")**

Options on the Dow Jones Equity Real Estate Investment Trust ("DJR") are slated for listing and trading on the Chicago Board Options Exchange ("CBOE") on April 19, 1999. The DJR index is capitalization weighted and is currently composed of 114 equity Real Estate Investment Trusts ("REIT"). The index is designed to measure the performance of 95% of the market capitalization of the equity REIT investable universe. The equity REITs in the index represent eleven distinct property classifications (e.g., office property, apartments, shopping centers, hotel/restaurant, etc.). In addition, the component equity REITs are diversified by geographical region; representing real estate investments throughout much of the United States. The base date for the DJR index is January 2, 1990, when the index level was set at 100.00. DJR options are cash settled and European style exercise.

The securities currently included in the index trade on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation System ("NASDAQ") National Market System. This circular explains the margin and capital treatment applicable to transactions in DJR options.

MARGIN

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

The DJR index is considered broad-based for margin purposes as component securities are diversified across a number of property classifications, and the index encompasses a number of sectors or industries in terms of the type of business for which the properties are utilized. Therefore, option writers are subject to the margin requirements specified in CBOE Rule 24.11(b)(i). The margin requirement for a short put or call on a broad-based index is 100% of the current market value of the contract plus 15% 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 is required for a DJR 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 is required for a DJR 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 DJR call. In the case of a short DJR 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 is 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), DJR options and "permitted offset" positions of DJR options market–makers may be margined on a basis which is satisfactory to the market-maker and carrying broker-dealer. A qualified stock basket is eligible for permitted offset treatment. In the case of the DJR index, the basket must contain no less than 95% of the capitalization in the index, in order to qualify as a permitted offset.

CAPITAL

The DJR index does not qualify for broad-based treatment for capital purposes in that it is not fully representative of the overall market**. Therefore, DJR index options are treated as narrow–based for capital purposes.** Under risk–based haircuts, the haircut is equal to the maximum potential loss for all DJR 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] For those firms not utilizing risk–based haircuts, the haircut will be calculated pursuant to SEC Rule 15c3–1a(b).

An offset between DJR options and qualified stock baskets is available under risk-based haircuts. Again, 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.

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

Questions regarding the margin and capital treatment of DJR options should be directed to Jim Adams at (312) 786–7718 or Rich Lewandowski at (312) 786–7183.