

**FREQUENTLY ASKED  
QUESTIONS BY INSURANCE  
PROFESSIONALS WHO ARE  
CONSIDERING**

**FLEX<sup>®</sup> OPTIONS**

**CBOE<sup>®</sup>**



## **WHAT ARE FLEX® OPTIONS?**

FLEX® options are customizable options where users define their own terms. They differ from standard listed options in that they have no pre-determined expiry dates or strikes.

### **What degree of customization is allowed for a FLEX® option?**

- Expiry can be any business day going out 15 years
- Any strike to two decimal places, expressed either as a fixed strike, or a percentage strike
- Exercise style either European or American

### **Does the exchange have exotic options?**

Currently FLEX® options can be “vanilla” or binary. Averaging Options (or Asian Options) and Cliquets are in development.

### **Can FLEX accommodate point-to-point with a cap trades?**

Yes. CBOE refers to “point-to-point with a cap” trades as call spreads. CFLEX® can accommodate multi-leg strategies with up to eight legs.

### **Who is the counter-party when trading FLEX options?**

The counter-party is the Options Clearing Corporation (OCC). Trades may be made with any number of other market participants, but then it is renovated to the OCC who stands as the buyer to every seller and the seller to every buyer.

## **Are S&P 500® options traded on CFLEX® regulated by the CFTC or SEC?**

S&P 500 options traded on CFLEX® are securities options, regulated by the SEC.

## **What type of account do I need to trade FLEX® options?**

As with standard listed options, FLEX options need to be held in a SEC regulated securities account that is approved for options trading. Securities accounts are not the same as futures accounts, and have different margin requirements and rules.

## **What is the process for trading FLEX options?**

FLEX® options are traded in a two-stage auction process via CFLEX, an electronic trading platform for customized options.

The first stage, known as T1, is designed to allow time for liquidity providers to evaluate the custom option that has been created as a “Request for Quote”, or “RFQ”. No trading occurs during T1 – responses simply come in for the submitter of the RFQ to review. T1 can be set for between 3 seconds and 10 minutes by the submitter of the RFQ. The RFQ can only be submitted by a Trading Permit Holder of the Exchange acting on behalf of a customer. End customers can be given a “view only” login to monitor the process.

After the first stage has expired, the second stage, known as T2, starts – it can last for a maximum of 5 minutes. During this stage the submitter of the RFQ is the only person who can trade against the various responses.

## Can I strike off the close?

Yes. Suppose you wanted to trade a 1-year index call option struck at 100%. Your broker would submit your RFQ and responders would submit markets expressed in % terms as well. Suppose the best offer was 5% and you buy the option at that level. Assume the index closes at 1300.00. You would then be long a 1-year 1300 call and you would have paid \$65.00 (i.e. 5%) per option.

## Can you explain how to calculate how many contracts I need?

Unlike OTC where size is expressed in notional amounts, FLEX size is expressed in contract amounts. For instance, if you need \$2.76 million notional, you must convert that number to a contract amount. Since each SPX options contract has a 100 multiplier (i.e. 100 units), the notional for each contract equals 100 times the level of the index. So if the index is at 1297.89, one contract equals \$129,789 notional. If you need \$2,760,000 notional, you simply divide \$2.76 million by \$129,789 to discover the number of contracts needed ( $\$2,760,000 / \$129,789 = 21.27$  contracts). CBOE does not trade fractional contracts; therefore, your trade size is 21 contracts. The notional amount of your trade is  $21 \times 100 \times 1297.89 = \$2,725,569$ . This leaves a residual mismatch of \$34,431.

## So I might not get the exact notional I need?

Correct. If you need more granularity, you can trade options on the XSP, which is 1/10 the size of the SPX. Expanding upon the previous example, the underlying quote would be 129.79, and the multiplier would still be 100, so the notional amount per XSP contract would be \$12,979.



Three of these “mini” contracts would reduce the notional mismatch in the example to \$4,506.

Other indices that also have smaller sizes are the Nasdaq-100 (MNX = 1/10) and the DJIA (DJX = 1/100). CBOE lists options on RUT, but the Exchange does not list a “mini” contract on that index.

### **How do CBOE binary options compare to OTC digital options?**

CBOE binary call options pay a fixed amount (\$100 per contract) if the underlying settles at or above the strike price. CBOE binary put options pay \$100 if the index settles below the strike price. They are priced between \$0.00 - \$1.00. For instance, if you wanted a payout of \$100,000 and you purchased a 1300 call, you would need to buy 1,000 contracts (\$100,000 payout / \$100 fixed payout amount.)

OTC digital options are priced as a percentage of the payout desired. Suppose you needed a 2.6% payout on \$3.1 million notional (\$80,600). Using CBOE binaries, you would need \$80,600/\$100 (i.e. 806 contracts) with the same strike as the OTC strike.

## Are customer positions segregated in any way from the clearing member's own positions, from the point of view of the OCC?

Yes, customer and firm positions are carried in separate accounts at OCC. Position accounting, margin, settlement and collateral are all done separately.

## If yes, is there any facility for customer positions to be held and effectively novated from a failed clearing member to a new clearing member?

Not at the current time. The transfer out would have to take place prior to failure; once a clearing member fails, the positions would be liquidated.

## Are the rules for OCC clearing set by the CFTC or the SEC?

OCC is regulated by both the CFTC and SEC. Whatever type of product being cleared (securities or futures) dictates which rules apply. For example, FLEX<sup>®</sup> options are regulated by the SEC; but futures contracts, such as VIX futures, are regulated by the CFTC.

## Can you explain the three levels of credit protection at the OCC?

The OCC guarantees that your option will perform through three layers of protection:



**1st layer of protection:** The OCC continuously keeps collateral from all clearing members; this collateral can be used to fulfill the obligations of your positions.

If there is not enough value in the collateral then the OCC will use funds from its 2nd layer of protection.

## **2nd layer: The pool**

The pool is ready cash (and/or highly liquid instruments) that has been gathered via clearing fees (OCC collects a \$0.02 fee for every contract traded on all U.S. option exchanges). If this pool is still not enough to cover the obligation, then OCC moves to its third layer of protection.

## **3rd Layer: Solvent Clearing Members.**

In the event of default of a clearing member, the remaining solvent clearing members can be tapped to collectively come up with the remaining shortfall.

OCC inserts itself between your clearing member and the clearing member who cleared the other side of the transaction. OCC protections are there to protect the marketplace from the failure of a clearing member. OCC does not insert itself between you and your clearing broker. In the event of a clearing member failure, OCC would liquidate the clearing member's collateral and positions and turn the proceeds over to the court appointed trustee.

## **If a client defaults, is there ever a case where non-defaulting clients' money would be used to cover losses?**

Only in the case where the non-defaulting clients' money is at the same clearing member as the defaulting client (and the defaulting client's failure was sufficient to make the clearing member insolvent). OCC safeguards are between your clearing member and all other clearing members. If a defaulting client is at a different clearing member than the non-defaulting customer, the non-defaulting client money is never at risk.

29.46	488.07	488.19	3	117.02	20.84	-0.29%	-0.18
117.00	20.83	20.84	370	21.31	31.66	-0.84%	-0.50
21.31	31.65	31.66	69	34.51	33.43	-1.59%	+0.22
34.51	33.43	33.44	82	29.79	21.35	0.64%	+0.36
29.79	21.35	21.37	3	35.87	35.87	1.09%	+0.36
35.87	35.87	35.87	17			-1.55%	-0.47
						-0.47%	-0.10
						-1.86%	-0.68

## What are the Initial Margin requirements for someone selling an option; what would the Variation Margin requirements be?

OCC assesses margin requirements on the clearing member on an omnibus basis, not on the individual customer accounts. How much a customer is charged by their clearing broker would depend on the margining scheme the clearing broker puts in place. If the clearing broker is using portfolio margin, the regulatory minimums and other information can be viewed here: <http://optionsclearing.com/risk-management/cpm/>

## What is acceptable collateral?

Acceptable collateral from a clearing member is limited to cash and U.S. Treasury securities with maturities less than one year. An insurance industry initiative through the NAIC is under way for clearinghouses to accept corporate debt securities, but they are not acceptable at this time.

## Is the amount of money in the OCC pool publicly available information? How is it funded?

The OCC's Clearing Fund, which each clearing member is required to contribute to via a \$0.02 charge per contract on every transaction, is currently \$2.8 billion. OCC's financial resources are posted online: <http://optionsclearing.com/risk-management/default-rules/financial-resources.jsp>



## **What is the impact on FLEX® of extending standard SPX expiries to 5 years?**

All market participants should benefit from more transparent pricing in long-dated options. Because the OCC nets positions for risk purposes across FLEX® and standard listed options, extending the standard listed maturities should be helpful for price efficiency in FLEX®. Liquidity providers that sell FLEX® options will get offsets from any standard options they own. Having a standard 5 year option will help liquidity providers match the risks more efficiently for longer dated FLEX® options.

## **Are there other CBOE initiatives that will help insurers?**

CBOE Futures Exchange<sup>SM</sup> (CFE®) is developing a new design for Variance Futures. This new design will be a better match to the cash flows of current OTC variance swaps. The addition of 5 year options to the SPX should also help with liquidity for the Variance Futures as SPX option positions are considered when margin for Variance Futures is calculated.

For an online version of this document see:  
**[www.cboe.com/insurance](http://www.cboe.com/insurance)**

Options involve risk and are not suitable for all investors. Trading FLEX options may not be suitable for all options-qualified investors. Prior to buying or selling an option, a person must receive a copy of Characteristics and Risks of Standardized Options. Copies are available from your broker, by calling 1-888-OPTIONS, or from The Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, Illinois 60606 or at [www.theocc.com](http://www.theocc.com). The By-laws and Rules of The Options Clearing Corporation govern its policies with respect to certain subjects discussed in this document. CBOE®, Chicago Board Options Exchange®, CFLEX®, CFE®, FLEX® and FLEXible EXchange® are registered trademarks and CBOE Futures Exchange, SPX and XSP are service marks of Chicago Board Options Exchange, Incorporated (CBOE). S&P® and S&P 500® are trademarks of Standard & Poor's Financial Services, LLC and have been licensed for use by CBOE. All other trademarks and servicemarks are the property of their respective owners.

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