The ChicagoBoard Options Exchange

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December 7, 1998

Mr. Michael Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
450 5th street, N.W.
Washington, DC 20549

Re: No-Action Request Regarding Futures Short Options Value Charge for Accounts of Options Market Makers

Dear Mr. Macchiaroli:

The purpose of this letter is to request that the Division of Market Regulation ("Division") not recommend any enforcement action to the Securities and Exchange Commission ("SEC" or "Commission") if broker-dealers treat futures short options value in the manner described below. This letter is being submitted by the Clearing Procedures Committee (Regulatory Sub-Committee)[1] (the "Committee") of the Chicago Board Options Exchange ("CBOE"). Specifically, the Committee requests that broker-dealers, which are members of Options Clearing Corporation ("OCC"), be permitted to not take the deduction provided in Rule 15c3-1b(a)(3)(x) (Short Options Value Charge or "SOVC") in computing net capital with respect to short futures options positions that are carried on behalf of options market makers or specialists, and subject to the haircut provisions of Rule 15c3-1 Appendix A.

The Committee believes that the other financial requirements which are applicable to such accounts provide adequate safeguards, and the SOVC is unnecessary and excessive. In particular the Committee believes that sufficient reliance can be placed upon the risk reducing provisions of the current theoretical options pricing method to determine capital charges for options, futures, and other related instruments. Requiring the SOVC unnecessarily increases business costs and poses a risk of clearing firm failure due to excessive charges in unstable markets. These issues are further discussed below.

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[1] The Committee is a standing committee of the CBOE consisting of representatives of member firms, CBOE Regulatory Services Division, and OCC. The Committee's mission is to interact with the Regulatory Services Division regarding regulatory issues such as net capital, margin, and other financial operational issues. The Committee consists of the following firms: AB Financial, L.P., ABN AMRO/Chicago Corp., ABN AMRO/Sage Corp., Bear Stearns & Co., First Options of Chicago, Inc., Harris Trust & Savings Bank, Hull Trading Company, L.L.C., ING Securities, Futures & Options, Kessler Asher Clearing, Lakeshore Securities, Letco Trading L.P., LIT Clearing Services, Inc., Merrill Lynch Professional Clearing Corp., O'Connor & Co. L.L.C., PAX Clearing L.P. and Tower Trading.

Theoretical Pricing Charges

On March 15, 1994 the Division issued a no-action letter to Mary L. Bender of the CBOE and Timothy Hinkes of OCC (the "1994 Letter") that allowed broker-dealers to employ a theoretical options pricing model to calculate capital charges for listed options and related positions, including futures and futures options. Rule 15c3-1 was amended on September 1, 1997 to include the haircut methodology described in the 1994 Letter. Currently the only approved options pricing model is OCC's Theoretical Intermarket Margining System ("TIMS"). In approving this new haircut methodology the Commission agreed that the capital charges were adequate to cover the risk in a market maker's account.

Supporting Arguments for Elimination of the SOVC

The SOVC requires that a clearing firm take a capital charge equal to 4% of the aggregate market value of short futures options sold by customers. The definition of customer includes the accounts of options market makers and specialists who utilize futures options to hedge their securities options trading activity. The 4% charge is purely an "add on" charge which has no relationship to risk. In fact, in situations where a firm's customers have long options or futures which more than offset the risk of the short options, there is no reduction in the SOVC. The charge is identical whether the short options are hedged or naked.

On July 16, 1998 the Commodity Futures Trading Commission removed the SOVC from its net capital rule. We understand that the SEC has elected not to eliminate the charge from Rule 15c3-1 at this time. However, when applied to the accounts of options market makers whose accounts are haircut under Rule 15c3-1, the Committee believes the charge to be excessive. The current haircuts on such accounts provide more than adequate financial protection to the capital of the carrying broker-dealer.

By requiring the maintenance of additional but unnecessary capital the charge significantly increases the cost of doing business. Further, the Committee is concerned that due to the nature of the charge, a significant market move could increase short futures options market value at a clearing firm. This could result in the clearing firm being in capital violation and forced to liquidate positions when, in fact, there may be no risk problem whatsoever.

For all of these reasons, the Committee respectfully requests that the Division not recommend enforcement action if clearing broker-dealers do not take the SOVC for the accounts of options market makers and specialists.

Sincerely,

Steven A. O'Malley
Chairman

Clearing Procedures Committee
(Regulatory Sub-Committee)