Interpretation Memo

Member Firm Regulation

NYSE
New York
Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

Number 90-3
May 22, 1990

PLEASE ROUTE TO FINANCIAL AND OPERATIONS OFFICER/PARTNER AND COMPLIANCE AND MARGIN DEPARTMENTS

TO: MEMBERS, MEMBER ORGANIZATIONS AND HANDBOOK SUBSCRIBERS

SUBJECT: UPDATE OF INTERPRETATION HANDBOOK FOR SEC RULE 15c3-1 AND NYSE RULE 325(c)(1) REGARDING DEDUCTIONS APPLICABLE TO CERTAIN LONG UNLISTED OPTIONS CONTRACTS

SEC Rule 15c3-1

The attached no-action letter issued by the staff of the SEC, dated January 31, 1990, provides interim conditions under which broker-dealers may treat a long unlisted option, for purposes of Appendix A to the SEC's Rule 15c3-1, as a listed option when the underlying security is a Treasury bill, note or bond. The treatment applies when the counterparty to the option is: (i) a registered broker-dealer or government securities broker or dealer with net capital or liquid capital after haircuts exceeding $25,000,000; (ii) a bank as defined in Section (3)(a)(6) of the Act with a net worth exceeding $100,000,000; (iii) a foreign bank with net worth exceeding $500,000,000; (iv) a registered investment company with assets exceeding $100,000,000; or (v) a registered clearing agency.

Subsequent to the issuance of the no-action letter the staff of the SEC advised that the information to be filed on a quarterly basis, as required by item (2)(E) of the letter, is to be filed with the designated examining authority on a calendar quarter basis at the time of filing of the FOCUS Report and is not to be filed with the SEC.

NYSE Rule 325(c)(1)

NYSE Rule 325(c)(1) does not allow any value in computing net capital for long options which are not obligations of a clearing agency or are not guaranteed by a member organization. This was adopted to consider the creditability of the endorser or guarantor of the option. The primary OTC options market at the time was in NYSE listed securities and options for Treasury securities were not actively traded by member organizations. In adopting this provision the Exchange recognized the nature of the securities markets and the risks attendant to equity options and recognized them, for value, only to a limited

extent. As noted, the SEC no-action letter addresses options for the purchase or sale of Treasury bills, notes or bonds and limits counterparties to highly capitalized financial institutions. Presumably the Commission's staff concluded that in instances where the underlying securities are Treasury bills, notes or bonds, the market is institutional in nature and the qualifications of counterparties strictly limited, this temporary no-action position is justified. The risk factors which motivated the Exchange adoption of Rule 325(c)(1) are recognized in a manner consistent with the purposes of Rule 325. Consequently if the terms and conditions of the interim no-action letter are strictly adhered to and solely for such period of time as the no-action letter remains in effect, the Exchange will permit recognition of unlisted option instruments as detailed in the Commission's no-action letter as consisting and conforming with Rule 325(c)(1) and the purpose for which it was adopted.

Any question with regard to these matters should be directed to your Coordinator.

Also attached are updated and reformatted handbook pages which are being distributed as replacements for existing pages. The following should be carefully reviewed before insertion into the handbook.

SEC Rule 15c3-1

Page & Reference	Subject
285, App. A (a)(1)/01	TCO options considered as listed.
285, App. A (a)(1)/02	Unlisted long option on Treasury bill, bond or note may be treated as listed.
299, App. A (c)(10)/02	Long unlisted call written by a customer (with short proprietary security) may be treated as listed.

NYSE Rule 325

3250, (c)(1)/01	Unlisted long option on Treasury bill, bond or note may be treated as listed.

Remove Pages	Add Pages
283 - 449	283 - 308
3225	3225, 3250

RETAIN ALL INTERPRETATION/INFORMATION MEMOS FOR FUTURE REFERENCE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

January 31, 1990

Mr. Salvatore Pallante
Senior Vice President
New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

Mr. Thomas Cassella
Vice President
National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, D.C. 20006

Dear Messrs. Pallante and Cassella:

We have received numerous comments concerning the deductions applicable to unlisted option contracts under Securities Exchange Act ("Act") Rule 15c3-1 (17 C.F.R. § 240.15c3-1).

For purposes of this letter, unlisted option contracts are those option contracts not traded on a registered national securities exchange or facility of a registered national securities association. Rather, unlisted options are separately negotiated transactions between the broker-dealer and a counterparty. Frequently the obligation to perform on an unlisted option contract is not margined and the party that purchased the option is subject to the risk that the counterparty may default. The credit risk to the broker-dealer that holds a long position in unlisted options is reflected in the treatment accorded unlisted options throughout Rule 15c3-1. Because of the credit risk associated with long unlisted options, Rule 15c3-1 generally does not recognize the risk-reducing benefits of offsetting positions that include those options, as it does for listed options. 1/

1/ Paragraph (c)(2)(i)(B)(2) of Rule 15c3-1 requires a broker-dealer to deduct from net worth all value of the unlisted option in excess of the intrinsic value of the unlisted option. Intrinsic value of an option is the

(continued...)

Generally, that credit risk is the intrinsic value of the long unlisted option. 2/ The broker-dealers that purchase unlisted options point out that these options have been frequently used by financial institutions without adverse consequences despite the lack of margin. They recognize the credit risk in the long option but contend that limited recognition should be accorded at least where those options are sold by credit-worthy institutions, and where the underlying security is a Treasury security. They urge that the Commission should, until the matter can be further studied and analyzed, provide interim relief in narrowly defined circumstances. Furthermore, they suggest that unlisted options should be allowed for hedging or risk-reducing purposes where the credit risk is sufficiently margined to prevent counterparty loss.

Based on the circumstances described above, the Division of Market Regulation will not recommend any action to the Commission if a broker-dealer treats an unlisted option for purposes of Appendix A to the net capital rule where the underlying security is a Treasury bill, note or bond as a listed option 3/ under the following circumstances:

(1) The broker-dealer has possession or control of (A) the security underlying the option or (B) an escrow receipt from a bank defined in Section 3(a)(6) of the Securities Exchange Act for the underlying security containing a representation by the bank that the bank will not release the security except on instructions

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1/(...continued)
financial benefit to be derived if the option is exercised immediately, reflecting the difference between the exercise price and the market price of the option. Appendix A requires a broker-dealer to deduct as to an uncovered long unlisted option the lesser of the applicable haircut on the underlying security or the value attributed to the option.

2/ For purposes of this letter, the intrinsic value may be defined as follows: (i) in the case of a long position in an unlisted put option, the excess of the exercise price of the unlisted put option over the market value of the underlying security; and (ii) in the case of a long position in an unlisted call option, the excess of the market value of the underlying security over the exercise price of the unlisted call option.

3/ Unlisted options should continue to be valued at intrinsic value for net capital purposes.

from the broker-dealer who has possession of the escrow receipt and will turn over the security to the broker-dealer to fulfill the counterparty's option contract; or

(2) (A) The broker-dealer deducts from net worth in computing net capital the sum of:

(i) the amount by which the sum of the broker-dealer's current credit risk and the safety factor from unlisted options with one counterparty exceeds 5 percent of the broker-dealer's excess net capital; and

(ii) the amount by which the sum of a broker-dealer's current credit risk and the safety factors as to all counterparties exceeds 25 percent of the broker-dealer's excess net capital.

(B) "Current credit risk" shall equal, on a counterparty basis, the sum of all the intrinsic values of all long unlisted options reduced by the intrinsic value of short unlisted options written by the counterparty and margin, marks to the market or other required deposits received from the counterparty outstanding one business day or less.

(C) "Safety factor" shall equal one half of the percentages set forth in paragraph (c)(vi)(A) of Rule 15c3-1 applied, on a per counterparty basis, to the unlisted options held by the broker-dealer. For purposes of computing the safety factor, the broker-dealer shall assign the market values of the underlying securities represented by those unlisted options to the categories specified in paragraph (c)(2)(vi)(A) (with the percentages therein reduced by one half). Securities underlying short unlisted option positions may be netted against the securities underlying the long unlisted option positions only if the short option position is in-the-money.

(D) In order to comply with the provisions of part (2) to this letter, the counterparty to the option must be: (i) a registered broker-dealer or government securities broker or dealer with net capital or liquid capital after haircuts exceeding $25,000,000; (ii) a bank as defined in Section (3)(a)(6) of the Act with a net worth exceeding $100,000,000; (iii) a foreign bank with net worth exceeding $500,000,000; (iv) a registered investment

company with assets exceeding $100,000,000; or (v) a registered clearing agency; and

(E) The broker-dealer must provide the Division with information on a quarterly basis, in whatever form it thinks appropriate as to:

(i) the number of any options described above it has outstanding with all counterparties;

(ii) the value of the securities underlying the options;

(iii) the number and general classification of the counterparties to these options; and

(iv) the intrinsic values of the long unlisted options.

The Division believes the outlined treatment is a reasonable interim approach to the problem of recognizing the credit risk associated with unlisted options. The Division will determine whether the no-action position expressed in this letter should be continued, modified or terminated. We will be seeking assistance from your staff and industry representatives in order to arrive at a more comprehensive resolution of the questions involved concerning the treatment of unlisted options in the future.

Sincerely,

Michael A. Macchiaroli

Michael A. Macchiaroli
Assistant Director