



DIVISION OF
MARKET REGULATION

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

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

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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

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

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Mr. Thomas Cassella

4

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