Chicago Board Options Exchange

Richard Lewandowski
Vice President
Regulatory Division

Phone: 312 786-7183
Fax: 312 786-8054
lewan@cboe.com

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Mr. Michael A. Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

RE: SEC Rule 240.15c3-1a(b)(1)(iv)A

Percentage of the Daily Market Price of the Underlying Instrument Applicable to Option Specialists and Market-Makers for High Capitalization Diversified Indexes

Dear Mr. Macchiaroli:

A provision in Securities and Exchange Commission ("SEC" or "Commission") Rule 15c3-1a(b)(1)(iv)(A) is due to expire on September 1, 1999 [as is provided in (b)(1)(iv)(B)]. This expiring provision presently allows the capital charges ("haircuts") for non-clearing options specialists and market-makers to be computed based upon theoretical gains and losses over a -8% to +6% range of underlying index values (in reference to the current index value) for U.S. domestic high capitalization ("high cap") diversified indexes, over a -10% to +10% range for U.S. domestic non-high capitalization ("non-high cap") diversified indexes, and over a -4.5% to +4.5% range for foreign currency options (collectively referred to as the "lower market ranges" of underlying index and foreign currency values). Lacking this provision, the haircuts for non-clearing options specialists and market-makers would be required to be computed utilizing the wider market ranges currently applicable to broker-dealers in general: -10% to +10%, -15% to +15%, and -6% to +6%, respectively.[1]

[1] In the notice of amendments to Rule 15c3-1 effective September 1, 1997 (Release No. 34-38248, 62 FR 6474, dated Feb. 12, 1997), the SEC noted with respect to the lower market ranges applicable to market-makers that "The concession for market-makers and non-clearing specialists was based upon the important role that non-clearing specialist and market-makers perform in maintaining fair and orderly markets. The Commission is incorporating the reduced requirements for market-makers into the final rule in light of these considerations, however, this concession expires two years from the effective date of the amendments unless it can be demonstrated by the non-clearing specialists and market-makers that retention of reduced capital requirements is in the public interest."

The Chicago Board Options Exchange ("CBOE" or "Exchange") is writing to seek no action relief from the SEC to permit the application of the lower market ranges to continue in force for non-clearing specialists and market makers for such time until the final order or other relief is approved to allow for the continued use of the lower market ranges.[2]

The CBOE believes that the application of haircuts based upon theoretical options pricing (or risk-based) utilizing the lower market ranges has been highly effective. Neither the Exchange's experience nor its analysis of market data support a widening of the market ranges. Further, to do so would add to the competitive disparity which already exists between securities and futures index products. The CBOE is, therefore, requesting that effective September 1, 1999, the SEC continue, without expiration, the lower market ranges applicable to options market-makers on high cap and non-high cap diversified U.S. domestic indexes. Factors supporting retention of the present, lower market ranges are outlined below.

- There has been a significant reduction in the number of options market-maker deficit equity occurrences since the introduction of risk-based haircuts at the current market ranges.
- The wider market ranges applicable to other broker-dealers do not in general result in significant haircut increases when applied to market-maker accounts.
- Historical analysis from January 1990 forward reflects market moves which do not equal or exceed the current lower market ranges.
- The present lower market ranges applicable to options market-maker / specialist haircuts are already greater than the position requirements (margin) imposed upon

[2] This letter primarily addresses reasons for the continuation of the present market coverage tests for broad-based indexes. The CBOE has not studied the effectiveness of the present + (-) 4 1/2% test for foreign currency options; however, we are aware of no information which would call for an increase in this level.

both professionals and customers trading comparable index futures and futures options, placing securities index options traders at a competitive disadvantage to those trading in futures contract markets.

Significant Reduction in the Number of Market-Maker Deficits. The CBOE identifies and records the number and magnitude of deficit market-makers accounts on a daily basis.[3] Market-maker account equity, haircuts and net deductions are computed by clearing firms and required to be provided to the CBOE on a daily basis. As can be seen in the attached chart, there was a significant reduction in the number of deficits starting with the late 1992 through 1993 time period following the implementation of a risk-based haircut pilot program. The number of deficits declined further in 1994 when the use of the risk-based method for computing haircuts became fairly widespread, contemporaneous with the SEC Division of Market Regulation's issuance of a no-action letter allowing broker-dealers to utilize the options pricing approach.[4] For example, on average, the number of deficits per business day in December 1994 (38.76) were 72% lower than in December 1991 (138.24). Reductions in the number of deficits have continued up to the present. To a great extent, these reductions are attributable to the use of risk-based haircuts, although other broker dealer risk monitoring practices have also contributed. The risk-based haircut method has allowed clearing firms to manage both risk and capital use more effectively because the resulting capital charges are consistent with, if not always equal to, the risk analysis for a market-maker account. More importantly, market action taken to reduce exposure will also result in haircut reductions. This was often not the case under the former strategy-based haircut method.[5]

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[3] The equity in a market-maker's account is calculated by adding the value of all long securities, subtracting the value of all short securities, and subtracting the debit balance or adding the credit balance. The account is in a deficit if equity is less than zero.

[4] Letter from Brandon Becker, Division of Market Regulation, SEC, to Mary L. Bender, First Vice President, CBOE, and Timothy Hinkes, Vice President, The Options Clearing Corporation ("OCC"), dated March 15, 1994 ("1994 No-Action Letter").

[5] See former SEC Rule 15c3-1 subparagraph (c)(2)(x).

Further, it is the clearing firm that is ultimately responsible for settlement of all transactions of its market-maker customers. The clearing firm, therefore, has an economic interest in closely monitoring and limiting the risk exposure created by its market-maker customers. The lower market ranges for market-makers are sufficient given the added protection of clearing firm risk oversight. As noted above, options market-maker haircuts are calculated and reported to the Exchange daily. Additionally, the impact on clearing firm capital of market-maker net deductions and deficits is also accounted for daily and reported to the CBOE. Such daily scrutiny is not applied generally to the daily trading activities of other broker-dealers which are subject to the higher market ranges. Both the third-party clearing firm scrutiny and the daily monitoring by the Exchange support continued reliance upon the current market ranges for market-makers.

The Wider -10% to +10% and -15% to +15% Market Ranges Do Not Render a Significantly Greater Haircut Requirement. The CBOE analyzed market-maker high capitalization diversified index portfolios at five market-maker clearing firms on various dates in April and July 1999.[6] The analysis revealed that aggregate haircuts (combining all firms and both months) using a -10% to +10% market range exceeded aggregate haircuts using a -8% to +6% market range by only 4.7%. However, it should be noted that when viewing the firms individually, haircuts under the wider market range showed a significant increase at some firms. Further inquiry revealed that these clearing firms service market-makers that transact in both index options and individual stock options. Some of these market-makers tend to hedge their index portfolios with offsetting positions in individual stock options. The firms with significantly low percentage increases service market-makers that concentrate their business in indexes and tend to do their hedging purely with indexes. When the -10% to +10% market range is applied to index portfolios hedged with individual stock option portfolios, a substantial increase in the haircut results as such offsets are not recognized in the haircut calculation. In such cases, market-makers who have effectively reduced their risk will be unfairly penalized by the haircut increases resulting from the use of wider market ranges.

[6] Three of the firms from the April analysis were included again in the July analysis.

The CBOE and SEC staff have on numerous occasions discussed the need for permitting haircut offsets between index products, index stock baskets and the individual stock options based upon underlying securities contained in the related index. Additionally, Exchange members independently have raised this issue with SEC staff.[7] Until such offsets can be effectively recognized in the haircut methodology, an arbitrary increase in the market ranges over which the haircuts are assessed would be unnecessarily punitive to those market makers who employ such hedging strategies.

No Historical Observations of One Day Moves Equaling or Exceeding the Lower Market Ranges. A widening of the lower market ranges is unnecessary considering they are intended to cover one day moves and the fact that, historically, one day moves outside of the lower market ranges have not occurred and would be extremely unlikely. For example, for a recent Dow Jones Industrial Average ("DJIA") level of 10,784, an 8% move equates to 862 points. The largest one day moves in the DJIA since Jan. 1, 1990 have been:

-554.26	Oct. 27, 1997
-512.61	Aug. 31, 1998
380.53	Sept. 8, 1998
-357.36	Aug. 27, 1998
337.17	Oct. 28, 1997
330.58	Oct 15, 1998
-299.43	Aug. 4, 1998
288.36	Sept. 1, 1998
268.68	Mar. 5, 1999
257.36	Sept. 2, 1997
257.21	Sept. 23, 1998
-249.48	Sept. 10, 1998
-247.37	Aug. 15, 1997
-237.90	Sept. 30, 1998
-235.23	May 27, 1999

[7] See letter from Timber Hill, LLC to Michael Macchiaroli, SEC, dated June 10, 1997 .

Although historical observation cannot predict future outcomes, the SEC has traditionally relied upon historical precedent as a reasonable basis for establishing policy. The adequacy of the margin requirements of options exchanges, as well as those of the NYSE and the NASD, have been monitored quarterly for over 10 years on the basis of the frequency of five day market moves beyond the required margin level over the most recent five and one-half month period.[8] Isolated instances of larger market moves do not, and should not, impact the level of margin required. In fact, with the exception of two 5½ month review periods, 95% of all five day moves in the high cap domestic indexes during the period from 1988 through May 21, 1999, did not exceed 6.5%, which is less than the 8% market coverage provided on the downside of the market for index market maker haircuts.[9]

Additionally, market moves in the high cap indexes in today's environment are not proportional to the market moves when the -8% to +6% range was established in 1994.

In 1997, the DJIA was in the 7,000 - 8,000 range. For a DJIA level of 7,500 in 1997, an 8% move equated to 600 points. Given a current DJIA of 10,784, an 8% move represents a 44% increase over an 8% move in 1997 in terms of points [(826 - 600) ÷ 600]. The lower market ranges have, in effect, already been increased in terms of point moves, or the dollar value of the market move covered by the haircut. In real dollars, the market coverage is much greater today than it was in 1994.

Competitive Disadvantages In Respect of Comparable Index Futures and Options. Loss of the lower market range provisions would exacerbate competitive disadvantages currently besetting market-makers. As you are aware, the margin requirements for both professional and customer

[8] The procedures for monitoring option margin levels were provided under letter to Howard Kramer, SEC, dated September 30, 1988. These procedures were also reviewed with Brandon Becker and Holly Smith, SEC, and agreed to during a November 15, 1988, meeting in Washington, DC.

[9] The two 5½ month review periods in which a higher percentage was needed to cover 95% of all five day moves were June - Nov. 1998 and Sept. 1998 - Feb. 1999. The percentage needed in each period to achieve a 95% coverage level was 8.5% and 8%, respectively. In addition, the percentage needed to achieve a 95% coverage level reached 6.5% for only two review periods.

participants in the index futures and futures options markets are substantially lower than the requirements for comparable securities index options. While CBOE index options market-makers continuously have been subjected to haircuts based upon the -8% to +6 market coverage since 1994, the market coverage associated with comparable futures/options has consistently been lower. For example, in March 1998, the market range for S&P 500 futures index options was +/-3.3%, providing coverage for less than half of the market move required on the market downside for securities index options market makers. Today, the market range approximates +/-5%.

The situation is even more pronounced with respect to haircuts for other broker-dealers and margin required of customers and other non-clearing market participants. The -10% to +10% market range required of broker-dealers in general for haircuts on high cap indexes and the 15% margin requirement for other market participants has resulted in the migration of substantial order flow away from securities index products to those comparable instruments traded in futures contract markets.

This competitive situation has been so extreme, that the SEC Division of Market Regulation invited the CBOE and other options exchanges in 1997 to file rule changes to reduce the margin required of customers from the 15% level to 10%.[10] Additionally, the CBOE has been in detailed discussions with Division staff with respect to a risk-based, cross margin pilot for qualified market participants which would utilize the same basic method as is applicable to proprietary haircuts.

In the meantime, market participants are increasingly choosing the index futures products over securities index option products. The Exchange loses order flow to futures exchanges trading index futures and options that are economically equivalent to securities index options because of lower margin requirements in the futures industry. The CBOE has experienced a dramatic decrease in average daily contract volume in its S&P 100 options ("OEX") and S&P 500 options

[10] For reasons which are not relevant here, the options exchanges declined the Division's offer at that time. However, at its July, 1999 meeting, the CBOE's Board of Directors voted to authorize such a filing, which is expected to be submitted to the Division in the very near future.

("SPX"), much of which can be attributed to increased use of index futures and options. To illustrate, for 1994, the CBOE averaged 324,071 S&P 100 ("OEX") contracts traded on a daily basis compared to 106,911 contracts for 1999 (to date), a decline of 67%. Average daily contract volume in SPX for 1994 was 111,178 contracts versus 85,416 contracts for 1999 (to date), a decline of 23%. Given that the market range for futures and options on futures is less than the current, lower market ranges for market-maker haircuts, the Exchange believes it is unreasonable to increase the latter.

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In conclusion, a wider market range parameter for computation of market-maker risk-based haircut requirements on broad-based indexes is not supported by the data, is not needed to further the public interest or to provide additional protection to investors; and could further exacerbate the already intolerable competitive disparities between securities index options and index futures / options. The CBOE asks the Commission to continue the lower market haircut ranges for options market-makers.

As always, your attention to this matter is greatly appreciated. If you have any questions or would like any additional information, please feel free to contact me.

Sincerely,

Richard Lewandowski

enclosure

cc: D. Anderson ("PHLX")
M. Bender ("CBOE")
R. Hennessy ("NYSE")
S. Luque ("NASDR")
J. McNeil ("AMEX")
D. Rosedall ("PCX")