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93-99

DIVISION OF
TRADING AND MARKETS

September 30, 1993

Re: Over-the-Counter Options on Foreign Currencies --
Request for No-Action Position

Dear :

This is in response to your letter dated July 13, 1993 submitted on behalf of "W", a registered futures commission merchant (FCM) and securities broker-dealer, requesting that the Division confirm that it will not recommend Commission enforcement action against "W" if "W" enters into over-the-counter (OTC) options on certain foreign currencies as a principal under circumstances described in your letter. "W", a wholly-owned subsidiary of "X", is a member of several securities and futures exchanges, including the "Y", on which it trades foreign currency options for its own account as an upstairs dealer. "W" is also a member of "Z" and clears its own options trades on "Y".

You represent in your letter that "W" proposes to hedge its "Y" foreign currency options positions with an equal number of opposite "look alike" OTC options to which "X" will be the contra-party (the "OTC Options"). These OTC Options will be structured and executed in accordance with a Master Options Agreement that "W" will enter into with "X". The OTC Options with which "W" will hedge its "Y" options will be identical to the "Y" options in terms of underlying currency, size, type (i.e., put or call), strike price and expiration date. For example, if "W" sells on the "Y" 100 September 1993 Deutsche mark call options contracts at a strike price of $0.61, it will purchase from "X" 100 OTC Deutsche mark call options contracts at a strike of $0.61 and with a matching expiration date (September 11, 1993). The purpose of this trading strategy is to fix "W"'s market risk at the time the transactions are entered into. "W" will first establish the "Y" options positions and then, virtually simultaneously, place with "X" the offsetting OTC Options positions to establish the spread. This rapid execution of the OTC Options transactions will be possible because, in accordance with the Master Options Agreement, "X" will be obligated to buy or sell OTC Options from or to "W" immediately upon "W"'s request at a price per contract equal to the last sale price on the "Y" for options of the same type, class and series.

You stated in your letter that "W" proposes to use OTC Options to hedge its "Y" options because of the efficiency and risk reduction inherent in the arrangement with "X". At present, "W" hedges its "Y" currency options with forward contracts in the same currency. These forward contracts are always executed with "X" as the contra-party. The OTC Options will provide "W" with substantially more protection given the identical terms of the two sides of the spread. Furthermore, because of the proposed Master Options Agreement with "X", "W" will be able to execute offsetting OTC Option positions more quickly than it is now able to execute forward contracts.

Commission Rule 1.19[1/] generally prohibits an FCM from assuming any financial responsibility with respect to commodity options other than those traded on or subject to the rules of a contract market or a foreign board of trade. Rule 1.19 was adopted by the Commission's predecessor agency, the Commodity Exchange Authority, "to protect the funds of persons trading in regulated commodities through registered futures commission merchants."[2/]

As you noted in your letter, "W" would assume financial responsibility for the fulfillment of certain OTC foreign currency options in connection with the above-described trading program. Absent relief from the provisions of Commission Rule 1.19, therefore, "W" would be prohibited from assuming financial responsibility for the fulfillment of such options.[3/]

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[1/] Commission rules referred to herein are found at 17 C.F.R. Ch. I (1993).

[2/] 38 Fed. Reg. 28031 (October 11, 1973). The Commission recently proposed an amendment to Rule 1.19 to permit FCMs to assume financial responsibility for options permitted under Commission Rule 32.4 (i.e., "trade" options), provided a capital treatment for such options is referenced in Commission Rule 1.17(c)(5)(vi). 58 Fed. Reg. 43087 (August 13, 1993).

[3/] This prohibition would apply because the OTC options are not traded on or subject to the rules of a contract market or a foreign board of trade. (If the proposed amendment to Rule 1.19 were adopted, however, the prohibition would not apply to foreign currency options where "X", a major money center bank, is the counterparty). Rule 1.19 does not apply, however, to the "Y" options because Section 4c(f) of the Commodity Exchange Act (Act), 7 U.S.C. § 6c(f) (1988), provides that nothing in the Act shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange, such as "Y".

In connection with your request for relief, you have discussed with the Securities and Exchange Commission (SEC's) Division of Market Regulation (DMR) the appropriate haircuts to which the OTC options would be subject in calculating "W"'s adjusted net capital. DMR has agreed that the OTC options may be treated in the same manner as exchange-traded options, subject to certain conditions. Specifically, in computing its adjusted net capital, "W" will treat each "Y" foreign currency option and its look-alike OTC option as an option spread. Each leg of the spread will be valued at market value by reference to the mark-to-market value for the corresponding "Y" option at the end of each trading day. There will therefore be no net long or net short value for each option spread and the haircut charge per spread will be the minimum $62.50 set forth in a previous DMR letter on this subject. Such treatment will apply in lieu of any deduction required by Appendix A of the SEC's net capital rule.[4/] You also noted, however, that although "W"'s intent is to close out the OTC option leg of a spread immediately upon liquidation of the "Y" option leg, in the event "W" does not do so, "W" will haircut the uncovered OTC option in accordance with the requirements of Appendix A of the SEC's net capital rule.[5/] Certain other conditions agreed to by "W" in connection with the net capital treatment provided by the SEC, as set forth in your letter, relate to its treatment of premiums and margin with respect to OTC options,[6/] exercise rights pertaining to such options and information that "W" will furnish to DMR quarterly regarding such options.

You stated in your letter that "W" will be assuming little, if any, financial risk with respect to the OTC options that it will enter into as described above. First, "W" will enter into

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4/ 17 C.F.R. § 240.15c3-1a (1993).

5/ The Commission's proposed rule amendments referred to in footnote 2 would generally provide that the OTC options discussed herein be treated for purposes of computing an FCM's adjusted net capital in accordance with Appendix A of the SEC's net capital rule. Since DMR has agreed to give special treatment to the options discussed herein rather than imposing a strict application of Appendix A, the Division believes it is appropriate to provide similar relief.

6/ Since "X" would not be deemed a customer of "W" for purposes of Section 4d(2) of the Act, 7 U.S.C. § 6d(2) (1988), funds received by "W" from "X" connection with the OTC options may not be placed in the segregated funds account maintained in accordance with the provision of that section of the Act and the rules promulgated thereunder.

an OTC Option only for the purpose of hedging its "Y" options. Second, its counterparty with respect to each OTC Option will be its parent, "X", which has a net worth in excess of $2.1 billion.[7/] Moreover, pursuant to the terms of the Master Options Agreement between "W" and "X", "X" will agree to enter into OTC Options with "W" that will be identical to the "Y" options in terms of underlying currency, size, type, strike price and expiration date. Finally, "W" will comply in all respects with the terms and conditions referred to above that have been agreed to by DMR which will be set forth in a letter from "W" to DMR.

Based upon your representations regarding the OTC foreign currency options which "W" would enter into with "X", the Division has determined that it will not recommend that the Commission institute enforcement action under Rule 1.19 based solely upon "W" assuming financial responsibility for such option transactions. This position is subject to the conditions agreed to between "W" and DMR referred to in your letter, as well as the following conditions: (1) "W" provides the Division's Washington headquarters with a copy of the Master Options Agreement between "W" and "X"; and (2) "W" provides the Division's Chicago regional office with a copy of the information it has agreed to provide to DMR on a quarterly basis concerning the OTC options, as set forth in item 5 on page 5 of your letter.

As noted above, the Commission has recently proposed to amend Rule 1.19 to permit FCMs to assume financial responsibility for trade options provided a capital treatment for such options is referenced in Commission Rule 1.17(c)(5)(vi). The Commission also proposed to amend the latter rule to provide for haircut treatment of such option positions in accordance with Appendix A of the SEC's net capital rule. If these rule amendments are approved, the Division's no-action position with respect to Rule 1.19 would become moot. At that point, however, the Division would not recommend that the Commission institute enforcement action under Rule 1.17 based solely upon "W" computing its adjusted net capital based upon haircuts for the OTC option transactions in accordance with the treatment specified in your letter and agreed to by DMR rather than as provided for in Rule 1.17(c)(5)(vi).[8/] Please note also, however, that if the Commission determines to withdraw the proposed amendment to Rule 1.19 referred to herein, this no-action position will expire.

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7/ "W" reported excess adjusted net capital of over $50 million on its financial report as of June 30, 1993.

8/ See footnote 5.

The views expressed herein are based upon the representations that you have made to us and are subject to compliance with the conditions stated herein. The relief granted is limited solely to the provisions of Rules 1.19 and 1.17 and does not affect any other duties or responsibilities of "W". Any different, changed or omitted facts or conditions might require us to reach a different conclusion. In this regard, we request that you notify us immediately in the event that the activities of "W" change in any way with respect to the OTC options referred to herein from those as represented to us.

Very truly yours,

Andrea M. Corcoran
Director