COMMODITY FUTURES TRADING COMMISSION
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DIVISION OF
TRADING AND MARKETS

July 26, 1995

95-65

Re: Commission Regulation 1.17(c)(5)(iii)

Dear Gentlemen:

This is in response to the letters of June 1 and June 12, 1995, and the letter of June 2, 1995, to Chairman Schapiro in which both urged the Commission to rescind Regulation 1.17(c)(5)(iii), or in the alternative to provide a measure of relief to futures commission merchants ("FCM") that are required to take the charge against net capital which is set forth therein. That section requires all FCMs to take a charge against net capital equal to 4% of the value of short options positions in customers' commodity accounts.

In your letters, you state that the charge fails to accurately reflect an FCM's risks associated with customers' short options positions, that such positions may in fact serve to reduce the risk of a portfolio that would carry greater risk absent the short options positions, and that the risks of such short options positions are already adequately addressed by the risk-based margin systems currently in use by all commodity exchanges in the United States and the corresponding undermargined capital charge. You contend that it is anomalous that under the present rule, when a customer adds a short option position to his account which reduces his portfolio's risk, such addition actually results in an increased charge against the FCM's net capital. You maintain that the charge, which was adopted in 1982, prior to the development of risk-based margin systems, and which was intended to serve as an additional capital safety factor for options positions, is excessive and no longer justified because of the use of risk-based margining systems to measure portfolio risk.

We believe that your argument--that the existing safety factor charge may be excessive where options are deep-in-the-money, that a charge against net capital for a position that is risk-reducing theoretically is not warranted, and that some interim relief would be appropriate--may have merit. Further, unlike futures, unrealized gains on options positions cannot be distributed to adjust the short options value capital charge. In considering your request, the Division has taken into account certain additional protections contained in the options margining and clearing system. Specifically, the Division notes that options premiums are held at the clearing organization and both long and short options positions are included in risk-based margin systems in computing the margin requirements in customer accounts. Also, in the margin system referred to herein, a minimum margin is assessed on all short options positions, regardless of how far out-of-the-money they may be.

Notwithstanding the foregoing, we do not believe that it would be appropriate to eliminate the short option charge in its entirety until the Commission has had the opportunity to more thoroughly review, among other things, whether it is appropriate to apply the same methodology for determining risk in a portfolio of commodity instruments, under a risk-based margining system, to the establishment of a net capital requirement for FCMs, and also whether and how safety factor charges built into that system should be adjusted for capital purposes. As you are aware, the Commission intends to undertake a comprehensive review of the Commission's net capital rule beginning in September. At that time we will consider the issue of the short options charge more fully. In contemplation of this review, the Securities and Exchange Commission staff has agreed to undertake a discussion of the futures markets' risk-based margining systems' parameters and the risk assumptions used by such systems.

In consideration of the foregoing, the Division will permit FCMs that meet certain criteria to apply for interim and limited relief from short options charges. The nature of the relief and the conditions under which such relief will be granted are more particularly set forth in the attachment to this letter. Such relief requires approval of the relevant designated self-regulatory authority, is limited to market maker or professional trader accounts, and should encourage an FCM obtaining such relief to request additional margin funds from its professional trader or market maker customers over and above that required by its risk-margining system. The relief also is premised on existing lines of credit remaining available as if no capital adjustment had been made. It is our understanding that in applying this relief the exchanges will take into account the protection of public customers.

Relief provided to FCMs consistent with this letter will be in the nature of a "no-action" position from the Division of Trading and Markets with respect to an FCM failing to take the charge against unadjusted net capital as required by Commission Regulation 1.17(c)(5)(iii). The Division's position is not

necessarily the position of the Commission or of any other unit within the Commission. Further, the position is based on the facts that are provided to us and our understanding of the existing margin arrangement for options used by risk-based margining systems. If any changes are made in the referenced margin system's parameters for assessing risk, this position may no longer continue to apply.

Regulation 15c3-1b(a)(3)(x) of the Securities and Exchange Commission ("SEC") is parallel to Commission Regulation 1.17(c)(5)(iii). Thus, any FCM which is also registered as a securities broker/dealer with the SEC, which plans to use the relief provided pursuant to this letter, must receive similar relief from the SEC. In this connection the Commission staff has consulted with the staff of the SEC's Division of Market Regulation, and they have stated that they will not recommend to their Commission that enforcement action be taken with respect to any firm properly claiming relief under this letter, provided that that firm obtains the approval of its commodities designated self-regulatory organization.

I also understand that you have been gathering data since February 1995 from your member-FCMs as part of a study of FCM capital requirements. In this connection, I expect that you will share the data collected with the Commission and have at least a preliminary analysis toward the end of the year. Separately, has agreed to provide us with certain month-end information on its Standard Portfolio Analysis of Risk performance bond calculation without the inter-commodity spreads for persons subject to this relief.

If you have any questions, please call Paul Bjarnason, Chief Accountant, for assistance.

Very truly yours,

Andrea M. Corcoran
Director

cc: