CFTC Letter No. 97-46

June 12, 1997

Division of Trading & Markets

Re: Short Option Value Charge

Dear :

This is in response to your letter dated January 24, 1997, submitted on behalf of the Joint Audit Committee (JAC), requesting further relief from Commission Rule 1.17(c)(5)(iii).[1] This rule requires a futures commission merchant (FCM) to take a charge in computing its adjusted net capital equal to four percent of the market value of commodity options granted (sold) by its option customers on or subject to the rules of a contract market or a foreign board of trade.[2]

The Division of Trading and Markets (Division) has previously provided certain relief from Rule 1.17(c)(5)(iii) in the form of a "no-action" letter.[3] This relief is available for any account carried for a floor trader or floor broker, if the net liquidating equity in any such account exceeds 150 percent of the margin requirement. The relief must be calculated on an account-by-account basis and can equal the amount by which the net liquidating equity in an account exceeds 100 percent of the margin required. The relief is limited, however, such that for any individual account, the credit against the charge based on four percent of short option value (SOV) in the account cannot exceed the amount of the charge attributable to that account and, on a firm-wide basis, the credit against the SOV charge for all customers combined cannot exceed 50 percent of the pre-relief charge. The relief granted was also subject to the following conditions: (1) the FCM is able to demonstrate, as of the most recent month-end prior to the date of the request for relief and for each subsequent month-end following the granting of relief, that the short options in the accounts for which credit is claimed constitute risk reducing positions; (2) the FCM agrees to maintain existing lines of credit in effect when relief is granted, including revolving subordinated debt agreements approved by the FCM's designated self-regulatory organization (DSRO); (3) the FCM agrees to maintain excess funds in segregation equal to at least 50 percent of the relief granted; and (4) the FCM's financial reports include a schedule in a specified format detailing the calculation of the credit against the SOV charge.

An FCM wishing to take advantage of the relief must request approval to do so from its DSRO. If the FCM demonstrates to the satisfaction of the DSRO that it meets the conditions of Interpretative Letter No. 95-65, the DSRO may grant relief. If the DSRO does grant relief, it must provide the Division with a copy of the letter to the FCM, which must contain any additional conditions imposed by the DSRO.

You stated in your letter that since the issuance of Interpretative Letter No. 95-65, the JAC has closely monitored the application of the relief. You further stated that from the JAC's experience and from discussions with FCMs, many FCMs believe that the conditions imposed on the relief granted in Interpretative Letter No. 95-65 are too restrictive and complicated, and that they are unable to expend the resources necessary to take advantage of the relief.[4] You report that only three FCMs have applied for such relief. Accordingly, the JAC is now requesting on behalf of its clearing member firms that the existing relief be modified as follows: (1) any customer account would be eligible for relief; (2) for any qualifying account (i.e., where the net liquidating equity exceeds 150 percent of margin requirements), there would be no SOV charge; (3) demonstration that the short options in an account for which credit against the SOV charge is claimed constitute risk reducing positions would be required when an FCM applies for relief initially and, thereafter, only upon request; and (4) the overall firm-wide limit on the amount of relief should be eliminated.

The Division has reviewed your letter and believes that certain additional relief from the SOV charge would be appropriate at this time. If more firms can qualify for relief in this area, this may improve market liquidity and may alleviate concerns that could arise if the risk of carrying short option positions for customers is concentrated at a few firms. Specifically, the Division: (1) will permit any customer, not only floor traders or floor brokers, to qualify for relief, provided the FCM's liability for net liquidating equity to that customer does not exceed five percent of the FCM's total net liquidating equity liability to all customers;[5] and (2) will require demonstration by an FCM that the short options in an account for which credit against the SOV charge is claimed constitute risk reducing positions when applying for relief and thereafter upon request, provided the DSRO makes such a request if the credit against the SOV charge, as reflected in a financial report or the monthly capital computation, is materially altered, and the DSRO requires such a demonstration by an FCM as part of any full scope financial compliance audit of the FCM, as of a randomly selected date prior to the inception of fieldwork at the FCM.[6] This will eliminate the need for an FCM to make such a demonstration as of each month-end. The Division notes, however, that it has not modified the condition set forth in the earlier relief letter requiring an FCM granted the relief discussed herein to include in its financial reports a schedule in a specified format detailing the calculation of the credit against the SOV charge.

Relief provided to FCMs consistent with Interpretative Letter No. 95-65, as modified in this letter, will continue to be in the nature of a "no-action" position from the Division with respect to any FCM failing to take the charge in computing its adjusted net capital required by Rule 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 have been provided to us and our understanding of the existing margin arrangements for options used by risk-based margining systems generally referred to as SPAN (Standard Portfolio Analysis of Risk). If any changes are made in the referenced margin system's parameters for assessing risk, this position may no longer continue to apply.

Rule 15c3-1b(a)(3)-(x) of the Securities and Exchange Commission (SEC)[7] is parallel to Commission Rule 1.17(c)(5--)(iii-). Thus, any FCM which is also registered as a securities broker-dealer with the SEC and plans to use the relief provided pursuant to Interpretative Letter 95-65, as modified by this letter, must receive similar relief from the SEC. In this connection, Division staff has consulted with 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 Interpretative Letter No. 95-65, as modified by this letter, provided that firm obtains the approval of its futures industry DSRO.

If you have any questions about this matter, please contact me or Paul H. Bjarnason, the Division's Chief Accountant. As you are aware, we are continuing to look at the capital rule to identify areas where it can be modernized, further harmonized with the SEC or otherwise made a more precise measure of market and default risk.

Very truly yours,

Andrea M. Corcoran

Director

[1] 17 C.F.R. §1.17(c)(5)(iii)(1996).

[2] The Commission originally adopted this rule in 1982 when exchange trading of commodity options in the U.S. resumed after a hiatus of nearly 50 years. An explanation of the Commission's rationale in adopting the charge is set forth in the preamble of the Federal Register release announcing its adoption. 47 Fed. Reg. 41513 (Sept. 21, 1982). See also Division of Trading and Markets Financial and Segregation Interpretation No. 8 -- Proper Accounting, Segregation and Net Capital Treatment of Exchange-Traded Option Transactions, *reprinted in* 1 Comm. Fut. L. Rep. (CCH) ¶7118 (Aug. 12, 1982).

[3] CFTC Interpretative Letter No. 95-65, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,495 (July 26, 1995).

[4] You stated that, with respect to the first condition cited above concerning a demonstration that short options in issue constitute risk reducing positions, an FCM's personnel must re-enter all positions in an applicable portfolio into a PC-based margin system, such as PC-SPAN, to make this demonstration. You report that many FCMs have claimed that they do not have the resources available to perform this task and are thereby precluded from seeking relief.

[5] If the five percent limit is exceeded, no relief would be available with respect to that particular account, but an FCM could still take relief attributable to other accounts.

[6] At least once every other year, a DSRO must undertake a full scope financial compliance audit of each member-FCM that carries customer accounts. See Division of Trading and Markets Financial and Segregation Interpretation No. 4-1 -- Advisory Interpretation for Self-Regulatory Organization Surveillance Over Members' Compliance with Minimum Financial, Segregation, Reporting, and Related Recordkeeping Requirements, at ¶26, *reprinted in* 1 Comm. Fut. L. Rep. (CCH) ¶7114A, at 7102 (July 29, 1985).

[7] 17 C.F.R. §240.15c3-1b(a)(3)(x)(1996).