

market maker haircuts under Rule 15c3-1(c)(2)(x) of the Act is less effective in that many hedged positions receive haircuts which are excessive while the haircuts for uncovered positions do not adequately reflect their potential risk.⁴

As reflected in the Regulatory Circular, the Office of the Chairman has determined to require all exchange members that clear options market maker transactions on a proprietary or market maker customer basis to calculate options market maker haircuts in accordance with a haircut methodology developed jointly by the Exchange and the Options Clearing Corporation ("OCC") and based upon the theoretical options pricing model of Cox-Ross-Rubinstein.⁵ The haircut treatment imposed by the Office of the Chairman is the same as that described in a recent Division no-action letter.⁶ The Office of the Chairman also has determined to allow an alternative calculation of haircuts for stock index baskets in accordance with the Division's staff no-action letter dated February 27, 1986.⁷ Although the 1986 no-action letter requires an operationally more cumbersome calculation, the Exchange believes the resulting lower haircuts more effectively recognize the hedging benefits of partial stock baskets offset by options and futures.

To the extent that this Exchange imposed haircut treatment would result in lower charges than currently required by Rule 15c3-1 under the Act, the February 27, 1986 and March 15, 1994 no-action letters provide the basis for the lower charges. To the extent that the Exchange imposed haircut treatment would result in higher haircuts, such greater requirements are being imposed

pursuant to the Exchange's authority under its Rule 4.10(b)(3).

To date, all but two Exchange members which clear the transactions of independent options market makers are calculating haircuts pursuant to the methodology described in this filing. We understand that the remaining two Exchange members are currently taking the operational steps necessary to comply with these parameters, and that these firms will be operationally prepared to calculate haircuts under these parameters by no later than early January 1995.

All Exchange market makers have been provided timely and adequate notice of the impending haircut changes through Exchange regulatory circulars and direct communication from their clearing members. The Exchange also provided several opportunities for special meetings with Exchange Financial Compliance staff to discuss the impact of the haircut changes. The new haircuts and implementation plan were also discussed at numerous meetings of the Exchange's Clearing Procedures Committee. The expected impact of risk-based haircuts was also discussed at a general meeting open to all Exchange members. It is our understanding that market makers on other exchanges have also been advised of the new charges. The implementation has proceeded smoothly.⁸

The Exchange believes that the imposition of these financial requirements is within the Exchange's authority, and that these requirements represent a more rigorous and reasoned basis upon which to assess capital charges. All market maker clearing firms are expected to be using the revised methodology of calculating haircuts by early January 1995. Nevertheless, the Office of the Chairman is using its authority under Rule 4.10(b)(3) to make it clear that the revised haircut treatment will be imposed now and equally across all positions of all options market makers, pending the Commission's consideration of a proposed rule to impose a similar

haircut treatment upon all broker-dealers.⁹

The Exchange believes that its proposal is consistent with and furthers the objectives of Section 6(b)(5) of the Act in that it will promote maintenance of fair and orderly markets and will contribute to the protection of investors and the public interest.

(B) Self-Regulatory Organization's Statement on Burden on Competition

CBOE does not believe that the proposed rule change will impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (a) By order approve such proposed rule change, or
- (b) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street NW., Washington, DC. Copies of such filing

⁴ The Exchange believes that the Commission and the Division of Market Regulation ("Division") share its concerns. In Chapter 5 of the staff's report concerning capital adequacy during the 1987 Market Break, the staff stated that, "The substantial losses of market makers * * * demonstrate that the present net capital treatment accorded to short options positions is inadequate to insure against the risk of major market movements."

⁵ See letter from Mary L. Bender, First Vice President, CBOE, and John C. Hiatt, Executive Vice President, OCC, to Michael Macchiaroli, Associate Director, Division, Commission, dated May 7, 1993.

⁶ See letter from Brandon Becker, Director, Division, Commission, to Mary L. Bender, First Vice President, CBOE, and Timothy Hinkes, Vice President, OCC, dated March 15, 1994. See also Securities Exchange Act Release No. 33761 (March 15, 1994), 59 FR 13275 (Proposed Rule Amendments to Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934).

⁷ See letter from Michael A. Macchiaroli, Assistant Director, Division, Commission, to David Marcus, Executive Vice President, Regulatory Services Group, New York Stock Exchange, Inc., dated February 27, 1986.

⁸ The new haircut methodology has been implemented at options market maker clearing firms on a staggered basis subsequent to thorough testing of each firm's capabilities by the Exchange, OCC, and other designated examining authorities. The first three firms began using the new haircuts on May 6, 1994. Other implementation dates were May 27, June 3, June 24, July 1, and July 22, 1994. The last two firms which clear independent options market makers are expected to have the operational capability to begin using the new haircut methodology sometime in the first quarter of 1995. One self-clearing broker-dealer also is preparing to implement risk-based haircuts; options market making is not a material part of the firm's business and a date for implementation has not yet been scheduled.

⁹ See *supra* note 6.