RG 94-06

DATE: January 6, 1994

TO: The Membership

FROM: Regulatory Services Division

RE: Expected Modification of Haircut Requirements for Options Positions

In the near future the Securities and Exchange Commission ("SEC") is expected to introduce a major modification in options capital requirements from the current strategy and premium-based system to a calculation based upon potential position risk as measured through an options pricing formula. The new haircuts are expected to go into effect in the Spring of 1994 and, generally, will result in haircut increases for naked positions and haircut reductions for hedged positions. This change has been sought after by the industry at large and is expected to provide a more rational method of assessing capital needs.

The SEC is expected to approve risk-based haircuts on a no-action basis and concurrently publish its proposed rule amendments for comment in the near future. At that time the Exchange will begin to test each clearing member's revised haircut program. Those firms which are operationally capable should be able to commence utilizing the proposed haircuts in the Spring of 1994. All market maker clearing firms are expected to be prepared before the effective date of the no-action letter. **Market makers are encouraged to discuss with their clearing firm the effect of the new haircut requirements on their individual accounts.**

Below is a brief history of the development of the risk-based haircut methodology.

After the market breaks of October, 1987 and October, 1989 the SEC Division of Market Regulation ("Division") indicated its intent to substantially increase the haircut requirements for naked options positions. While recognizing that the existing haircut on such positions was inadequate in many cases, the Exchange believed that the fundamental approach of the current haircut methodology was no longer valid.

The present haircut methodology was originally developed in 1975, and although the SEC has periodically approved requests for haircut relief from the Exchange (i.e., boxes, conversions, cross index positions, free allocation, etc.), the method of applying the haircut has not changed. Currently, haircuts are applied on each strategy within an options class, with little recognition of risk offsets between strategies.

At the request of the Division, the Options Clearing Corporation ("OCC") and the Exchange jointly developed an alternative haircut approach which would give credit to offsetting positions within a class, while also achieving the SEC's goal of increasing charges for naked positions. This approach requires all related positions within a class (i.e., options/stock, options/futures) to be grouped together and the profit or loss on the aggregate position to be computed across a range of five equidistant upside and five equidistant downside market moves. Theoretical options prices would be computed using the Cox-Ross-Rubinstein model currently used by OCC to compute clearinghouse margin requirements. Current implied volatility for each option series would be used in the calculation of theoretical values. The largest theoretical loss across the range of ten possible market moves would be the haircut on each class or a minimum charge per contract, if greater than the theoretical risk. The Exchange and OCC conducted a three month study in 1992 of twelve clearing members. The SEC mandated the following market moves for the study: equities +/- 15%, broad based indexes +/- 10%, and foreign currencies +/- 6%. This resulted, for example, in the haircut on equity options being computed at +/- 15%, +/- 12%, +/- 9%, +/- 6% and +/- 3%. As expected, the study resulted in lower charges for hedged positions and increases for naked positions.

In May, 1993 the CBOE and OCC submitted a proposal to the SEC requesting that the present strategy based haircut methodology be replaced by a risk based approach. To cushion the impact upon unhedged index positions, the proposal requested that for non-self clearing market makers the market move on broad based indexes initially be limited to + 6% and - 8%, rather than +/- 10%. A similar proposal was made to assess foreign currency haircuts at +/- 4 1/2%. The Exchange committed to conduct a study for nine to twelve months, of the effect of the new haircut requirements on the index options market. A recommendation to the SEC would be made at the conclusion of the study regarding the appropriate level of market coverage. After much discussion with market maker clearing firms, a minimum charge of $25 per option contract times the product multiplier was proposed. The minimum charge is also targeted for review during the initial implementation period.

Basket/derivatives offsets would continue much as they are today with the minimum charge of 5% of the basket value. Offsets would be recognized among certain broad based index products from 75% to as much as 90% of profits to offset losses, depending upon the characteristics of the indexes.[1]

Questions should be directed to Richard Lewandowski in the

[1] Offsets among broad based high cap indexes such as SPX and OEX would be set at 90%. In such non-high cap broad based indexes as Russell 2000 and the Mid Cap the offset would be set at 75%. Narrow based indexes would be treated as equity option products and no profit/loss offset would be recognized among these indexes.

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