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STATEMENT OF JOSEPH W. SULLIVAN
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REGARDING FEDERAL RESERVE BOARD MARGIN PROPOSAL

The failure of the Federal Reserve Board proposal to allow for long option/short stock hedges severely disadvantages the CBOE's competitive market-maker system, which depends on a large number of small individual traders, relative to large Wall Street trading houses.

The large Wall Street houses which clear and carry their own trading accounts, are exempt from any FRB margin requirements on their short stock positions; nor are they subject to any charges on such positions under the SEC's Net Capital Rule when the short stock position is hedged by a long option position that eliminates any market risk on the short stock. By contrast, the FRB proposal would subject CBOE market-makers, most of whom are carried by a clearing broker, to a 50% margin requirement on their short stock positions hedging long option positions.

For example, a CBOE market-maker who assumes a long position of 20 IBM April 260 option contracts (of 100 shares each) can effectively hedge his position by going short 2,000 shares of IBM stock at 260. The long option removes any risk of the short stock (and the short stock serves to reduce risk on the long option). Yet under the FRB's proposal, a CBOE market-maker would be subject to a $260,000 margin requirement (50% of the $520,000 market value of the 2,000 shares sold short) on an essentially riskless short position whereas a large trading

firm that clears for itself would be exempt from any requirement on the same position.

For other securities such as a warrant that are exchangeable or convertible into an underlying stock, the FRB has long waived any margin requirement on all investors and dealers alike on a short stock position that is hedged by a long position in the convertible security. An option covers the risk of a short stock position just the same as any other convertible security, yet the FRB has failed to apply the same margin principles in the case of a long option/short stock hedge in any brokerage account, even the account of an options market-maker.

Thus, the CBOE's many smaller, non-clearing market-makers who are vital to the strength of its competitive market-making systems are virtually precluded from hedging in the underlying stock by margin requirements that are totally disproportionate to the risks involved. As a result, margin requirements whose purpose is supposedly risk control are having the exact opposite effect of exposing option market-makers to much greater risk, thereby impairing their market-making capabilties to the detriment of all investors.

There are two possible explanations for this hopefully unintended irony. One is a lack of understanding on the part of the Federal Reserve Board as to how the options market functions and the purposes it serves. The other is maneuvering by large Wall Street specialist firms and other dealers to put the CBOE at a severe disadvantage to its present and prospective New York competitors.