

The clearing fund is available to OCC if: (1) a clearing member fails to fulfill its exercise or assignment obligations; (2) a clearing member fails to make any required payments to OCC; or (3) OCC suffers any loss or expense upon the liquidation of a clearing member's open long or short positions. If a clearing member's contribution to the clearing fund is insufficient for these purposes, the deficiency is paid out of the aggregate clearing fund and charged against all other clearing member contributors in proportion to their contributions. 25/ Clearing fund deposits are not refunded until a clearing member has ceased to be an OCC member, each of the firm's obligations with OCC have been fulfilled or closed, and all obligations have been satisfied. 26/

#### 4. STUDY OF THE FINANCIAL INTEGRITY OF THE OPTIONS MARKET

To examine the effectiveness of the complex controls and devices that the OCC and the Commission have established to provide financial protection to the options market and public investors, the Options Study obtained extensive financial data from OCC and the options exchanges. 27/ While the data covered most of the time during which listed options have been traded, special attention was given to the period of high stock and options volume and sudden price movements that occurred between April 13

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25/ OCC art. VIII, §5.

26/ OCC art. VIII, §7.

27/ Letters to AMEX, BSE, CBOE, MSE, NASD, NYSE, PHLX, and PSE, dated June 7, 1978, and letter to OCC, dated May 5, 1978.

and April 18, 1978 (the "April market surge"). This period was chosen to determine the effectiveness of OCC margin and clearing fund requirements and the Commission's net capital rule during a sequence of abnormal price movements and volume changes. During this period the DJIA increased approximately 44 points. NYSE volume increased from 31.5 million shares on April 13, to 52 million on April 14, and 63.5 million on April 17.<sup>28/</sup> OCC contract volume increased from about 225,000 contracts on April 13, to 443,000 contracts on April 14, to a high of approximately 619,000 contracts on April 17. These figures compare with a daily average OCC cleared contract volume of 192,000 contracts during the year July 1977 to June 1978.

While the DJIA increased approximately five percent (766 to 810) between Wednesday, April 12, and Monday, April 17, some of the more active stocks underlying listed calls increased in price ranging from five percent to eight percent. Premiums on the related options increased from 366 percent to 4,300 percent as set forth below: <sup>29/</sup>

<u>Stock</u>	<u>Up</u>	<u>Call</u>	<u>Up</u>
Digital Equipment	8.0%	April 40	483%
Disney	7.1	April 35	633
Dupont	8.3	April 110	4,300
Eastman Kodak	5.0	April 45	400
IBM	6.3	April 240	1,005
Polaroid	7.9	April 30	366

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<sup>28/</sup> Wall Street Journal, April 13, 14, 17 and 18, 1978.

<sup>29/</sup> Business Week, May 1, 1978 at 26.

During the April market surge, two of the OCC's eight largest members carrying market maker accounts (their size determined by the number of market maker accounts carried) could not meet the Commission's net capital requirements. On April 17, 1978, the accounts of 85 market makers were in a deficit condition and the net equity in the accounts of market makers in the aggregate declined from \$85.5 million as of April 14, 1978 to \$74.3 million as of April 17, 1978, a decline of approximately \$11.2 million. 30/

Due to sudden price and volume increases, OCC made variation margin calls on certain of its member firms on April 14, 17, 18, 20 and 25, 1978. The amount of the variation margin calls on these dates, the number of member firms on which calls were made, and the particular accounts carried at OCC which were affected by the calls were as follows:

DATE	Variation Margin Call Per Cent of Regular Mar- gin Deposits	Total Amount (000 omitted)	Number of Firms	Accounts		
				Market Maker	Customer (000 omitted)	Pro- prietary
4/14	10%	\$ 32,617	72	\$ 2,651	\$ 29,642	\$ 324
4/17	20	90,244	95	10,439	77,298	2,507
4/18	10	19,233	67	3,543	15,130	560
4/20	10	13,786	71	301	13,299	186
4/25	10	49,259	86	1,383	47,368	508

30/ Table No. 1 appended as Exhibit 5. Under normal conditions, between 30 and 40 marketmaker accounts may have a deficit.

During this period all OCC members satisfied their variation margin calls. 31/

a. Margin and Clearing Fund Deposits

In order to assess the adequacy of OCC's margin requirements and clearing fund deposits OCC conducted a computer simulated test in June 1978, based on the following hypothetical assumptions:

- Each (but only one at a time) of OCC's 50 largest clearing members - 18 of which cleared market maker accounts - failed on Friday, April 14, 1978;
- The premium and margin due to OCC by that firm, based on its April 13 activity, was collected Friday, April 14. This amount did not include the variation margin call made on April 14; and
- OCC liquidated the firm's positions on Monday, April 17, 1978, at the closing prices.

This period was used since, as previously described, it was one of unexpected and rapid price increases and as of April 17, 1978 option premium value were at their high or near their high for this period. Based on these assumptions and using OCC margin and clearing fund deposits available to OCC it was determined that of the 50 firms, 28 could have been liquidated without resorting to their clearing fund deposits. Of the 22 remaining firms, 15 would have had sufficient margin and clearing fund deposits to cover the cost of liquidation, and the remaining seven would not. The deficiencies would have ranged

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31/ OCC Submission, Vol. II, Sec. IV J, May 29, 1978.

from \$5,500 to \$930,000 with \$61 million in aggregate clearing fund deposits on hand. All seven firms which would have had inadequate resources cleared accounts of market makers.

Before this test was conducted, OCC had submitted to the Commission proposals to amend its margin and clearing fund deposit requirements in order to increase the margin for short term near-the-money options and to calculate the OCC member clearing fund deposit requirements on options premium values during the preceding quarter. To determine how implementation of the proposed changes would have altered the original test results, a second test was conducted using the same assumptions as in the first test but adjusting the margin and clearing fund deposit requirements to reflect the proposed changes. The second test showed that 34 of the 50 firms could have been liquidated without resort to their clearing fund deposits — six more than in the original test. However, the number of members whose margin and clearing fund deposits would not have covered the cost of liquidation also increased — from seven to eight — as did the hypothetical deficiencies which ranged from \$54,000 to \$1 million. Due to low premium values during the preceding quarter, however, the total clearing fund deposits on hand would have been only \$21 million. This amount would have sufficiently covered any deficit. As in the original test, seven of the firms which would have had inadequate clearing fund deposits cleared accounts of market makers. <sup>32/</sup>

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<sup>32/</sup> Letter from Marc L. Berman, Vice President and General Counsel, OCC, dated July 18, 1978.

The results of these tests indicated that OCC's margin and clearing fund deposit requirements provided OCC with adequate financial protection in the aggregate, and since the OCC proposals to amend its margin and clearing fund deposits requirements increased margin requirements for short near-the-money, near expiration options and measured clearing fund deposit requirements by premium value they were adopted. These tests also showed, however, that additional margin should be required from OCC members that clear market maker accounts. The following table demonstrates that, based on the assumptions made in OCC's tests, the greatest impact on the clearing fund would have come from OCC members clearing market maker accounts. This is because the positions and accounts of options market makers are netted at OCC whereas customer positions and accounts are not.

	Test 1				Test 2				
	Total Number of Firms	Average Margin Deficiency		Average Margin & Clearing Fund Deposit Deficiency		Average Margin Deficiency		Average Margin & Clearing Fund Deposit Deficiency	
		(\$in thousands)		(\$in thousands)		(\$in thousands)		(\$in thousands)	
	No.	\$	No.	\$	No.	\$	No.	\$	
Clearing Firms Not Carrying Market Maker Accounts	32	12	294	0	0	7	220	1	54
Clearing Firms Carrying Market Maker Accounts	18	10	793	7	316	9	571	7	462
Total	50	22		7		16		8	

Accordingly, the Options Study recommends:

OCC SHOULD REVIEW ITS MARGIN AND CLEARING FUND DEPOSIT RULES REGARDING OCC MEMBERS THAT CLEAR MARKET MAKER ACCOUNTS WITH A VIEW TO DETERMINING WHETHER IT WOULD BE APPROPRIATE TO INCREASE THEIR MARKET MAKER MARGIN DEPOSIT REQUIREMENTS IN ORDER THAT THE CLEARING FUND DEPOSITS OF OCC MEMBERS THAT DO NOT CLEAR MARKET MAKER ACCOUNTS ARE NOT UNREASONABLY SUBJECT TO THE RISKS OF THOSE THAT DO CLEAR THESE ACCOUNTS.

b. Market Makers and Market Maker Clearing Firms

The Options Study obtained financial data with respect to both market makers and OCC members carrying market maker accounts to determine the actual impact of the April market surge on their financial condition. Of the 22 OCC member firms which reported carrying market maker accounts, eight carried approximately 1,250 of the 1,400 (87 percent) market maker accounts. <sup>33/</sup> These eight firms each carried from 375 to 48 option market maker accounts.

While all 22 market maker clearing firms are subject to similar risks and requirements, the failure of one of the eight largest firms to honor its financial obligations would have the greatest financial impact on the options market. For that reason, the Options Study confined its analysis of the financial impact of the April market surge to the eight largest market maker clearing firms.

Six of these eight OCC members were specialized market maker clearing firms limiting their business almost exclusively to carrying

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<sup>33/</sup> Form A, appended as Exhibit 4.

options market maker accounts. In total, these six firms carried approximately 1,000 CBOE and PSE market maker accounts (71 percent of all market maker accounts) and only 36 non-market maker accounts. The CBOE has been designated as the financial examining authority for all six of these firms. The other two firms were integrated market maker clearing firms carrying approximately 250 market maker accounts doing business primarily at the AMEX and PHLX, and carrying approximately 36,000 customer accounts. The NYSE is the designated examining authority for these two firms.

Because carrying market maker accounts was only a part of the business of the two integrated firms, the adverse impact on their market maker accounts of the April market surge had a far less drastic effect on their net capital, as a percentage, than was the case for specialized firms. Although one of the integrated firm's deductions to net capital related to carrying market maker accounts increased from \$3 million on March 31 to \$7.2 million on April 17, 1978, that firm's net capital, in excess of that required, decreased only 13 percent. On the other hand, the excess net capital of five of the six specialized firms decreased by substantially larger percentages. Their net capital decreases ranged from 42 percent to over 100 percent during the same period, with two firms having net capital deficits.

The Options Study focused on the reasons that two of these eight OCC members carrying market maker accounts had been unable to comply with the Commission's net capital requirement as of April 17, 1978.



The rationale for concentrating on the firms most severely impacted is that the Commission's net capital rule, in establishing minimum financial standards, acts as a warning device to detect financial problems at an early stage. In this regard, the experience of the firms which encountered financial problems is the most relevant. One of these firms, Firm A, had a net capital deficit of \$800,000 on April 17, 1978, and the other, Firm B, had a net capital deficit of \$275,000. Both firms honored their financial obligations and by the next day, April 18, were in compliance with the Commission's net capital rule.

An analysis of the data with respect to these two firms shows that their net capital difficulties resulted from several causes: (1) a disproportionate concentration of an options class in the market maker accounts carried by the clearing firm in relation to the total open interest in that options class; (2) the net short positions in near or at-the-money options; and (3) the high ratio of market maker net capital deductions in relation to the OCC member's net capital.

The Options Study believes that each of the circumstances noted above indicates special options risks. The recommendations discussed below are necessary to better protect against the failure of an OCC member carrying market maker accounts during periods of abnormal market activity.

In addition, as discussed more fully below, the Options Study is also recommending that the Commission's net capital rule be revised;

(1) to require that market makers maintain a minimum equity; (2) to increase the deductions for options positions carried by a market maker clearing firm for its own or an affiliated market maker account; (3) to permit a market maker clearing firm one business day to obtain additional capital or market maker equity resulting from stock or options transactions in the market maker accounts it carries before the net capital deduction resulting from options market maker positions are applied; and (4) to reduce the net capital deductions for broker-dealers trading both on and off the floor of an options exchange where appropriate, to better reflect the risk limiting features of certain options strategies.

5. RECOMMENDED CHANGES TO THE NET CAPITAL RULE

a. Concentrated Positions

Examination of all of Firm A's accounts at OCC showed that Firm A held short positions that were not covered or hedged (uncovered short positions) in its combined market maker account at OCC in 151 options classes. Forty-eight of these uncovered short positions were equal to or in excess of 10 percent of the OCC total open interest in the options class. In 41 of these 48 short positions Firm A's uncovered short position was in excess of a 1000 contracts. In one class its uncovered short position was over 17 thousand contracts.

The number of classes and the percentage of the total open interest in an options class held in an uncovered short position in excess of a 1,000 contracts by the market maker accounts carried by Firm A were as follows:

Positions in Excess of a Thousand Contracts

Percent of open interest (less than 10%)	%	%	%	%	%	%
	10-14	15-19	21-24	25-29	30 & over	
Number of classes	22	21	11	3	5	1

Ten market maker accounts carried by Firm A in the aggregate caused a decline of almost \$5 million in Firm A's net capital between April 13 and 17, 1978. This decline was due to market maker losses in their options positions and an increase in market maker equity requirements under the net capital rule due to an increase in options premium values. A test of these ten market maker accounts was performed to determine whether the equity requirements for these market makers adequately comprehended the potential loss between April 12 and April 17, 1978. This test assumed that the positions held in these ten accounts did not change during the test period so that the losses, if any, would have come about as the result of price fluctuations. Of the 338 positions held in these ten accounts, the market makers equity requirements exceeded the hypothetical loss in 289 instances. Market maker equity requirements were insufficient for the remaining 49 positions. In 23, or almost half of these 49 positions, Firm A's uncovered short position at OCC was in excess of 10 percent of the OCC open interest in that class of options.

The Commission has long been concerned about the deductions that should be made for large positions in a single security in computing net

capital. In 1972, in its proposal to adopt the net capital rule, the Commission noted:

[It] has discovered a number of situations in which either because there were a limited number of market makers in a security or a broker-dealer had an unusually large position in a particular security, it became unlikely that such security, given the existing market conditions, could be sold at prices at or near the market price quoted in a recognized inter-dealer quotation system or exchange. 34/

To assure that a broker-dealer had sufficient capital when it maintained large long or short positions, the Commission required an additional deduction in computing net capital, equal to 50 percent of that normally required, for proprietary positions in a single security whose value exceeded 10 percent of a firm's net capital before the net capital deductions on proprietary positions. 35/

Although this provision applies to both proprietary stock and options positions, it does not apply to options positions in market maker accounts guaranteed by a market maker clearing firm. The Options Study believes that the same risks inherent in large proprietary options positions also exist in options positions that are guaranteed by a market maker clearing firm. A large options position however, should be defined as a percentage of the open interest in the options class rather than as a percentage of the clearing firm's net capital. The Options Study

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34/ Exchange Act Release No. 9891 (December 5, 1972).

35/ SEC Rule 15c3-1(c)(2)(vi).

believes, on the basis of the data that it reviewed, that any options position in excess of 10 percent of the open interest in an options class is an appropriate measure of a concentrated options position in which clearing firm problems may be experienced due to sudden price changes or in attempting to liquidate the position. An additional net capital deduction equal to 50 percent of the deduction otherwise required for each series in the concentrated options class is recommended to recognize the additional risks of these positions.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS NET CAPITAL RULE TO REQUIRE AN ADDITIONAL CHARGE IN AN OCC MEMBER'S COMPUTATION OF ITS NET CAPITAL FOR ANY NET LONG OR NET SHORT OPTIONS POSITIONS IN ALL MARKET MAKER ACCOUNTS GUARANTEED BY THE OCC MEMBER WHICH ARE IN EXCESS OF 10 PERCENT OF THE OPEN INTEREST IN THE OPTIONS CLASS. THIS DEDUCTION SHOULD BE EQUAL TO AN ADDITIONAL 50 PERCENT OF THE CHARGE OTHERWISE REQUIRED FOR EACH SERIES IN THAT OPTIONS CLASS.

b. Short Positions In Near Or At-the-Money Options

The Options Study examined 734 active market maker accounts as of April 14, 1978, and compared the market maker equity requirements to the loss in equity in the accounts, if any, between April 14 and April 17, 1978. Of the accounts examined, only 47 had losses in excess of the equity requirements. Although the positions could have changed during April 17, and additional equity may have been deposited to their accounts by some market makers, the Options Study is satisfied that the market

maker equity requirements generally provide adequate capital protection except for short positions in near or at-the-money options.

The price movement of near or at-the-money options series are generally more volatile than those of other series of a given options class and because of the leverage characteristics of options, substantial percentage changes in the options premium value can result from related small price changes in the underlying stock. For example, during the April market surge, with a five to eight percent change in the price of the underlying security, the premium value for Dupont April 110s increased approximately 4,300 percent; IBM April 240s approximately 1,005 percent; Disney April 35s approximately 633 percent; and Digital Equipment April 40's approximately 483 percent.

Most of the potential loss in the ten market-maker accounts carried by market maker clearing Firm A which created the greatest capital deductions to that firm was due to short positions in near or at-the-money options.

Currently, the Commission's net capital rule requires that a market maker have equity equal to 75 percent of the premium value of short option contracts trading at \$100 per contract and above and \$75 for those contracts trading at less than \$100, or the OCC member firm carrying the market maker accounts must deduct the deficiency in computing its net capital. In view of the extremely volatile price changes that can occur in near or at-the-money options positions the Options Study believes that this requirement

is insufficient with respect to such positions. The rule should be revised to better reflect the more volatile percentage price movements that can occur in near or at-the-money options. On the basis of the data that it reviewed, the Options Study believes that the net capital requirement can be made more sensitive to the risks of near or at-the-money options, by requiring that market makers have equity for such positions equal to the greater of (1) 75 percent of premium value, (2) \$75, or (3) 5 percent of the market value of securities underlying uncovered short options positions, reduced by the amount the options exercise price is in or out-of-the-money to recognize that as an option moves into or out-of-the-money its volatility, measured as a percent of price, decreases.

In the ten accounts carried by Firm A described above, the market maker equity requirements for 49 positions was \$1.4 million as of April 12, 1978. The hypothetical loss in these positions between April 12 and April 17, 1978 was \$2.6 million, or a net loss in excess of the market maker equity requirements of \$1.2 million. The bulk of this hypothetical loss, however, was accounted for by 19 positions which had losses in excess of \$10,000 of their equity requirements. The equity requirements for these 19 positions were \$1.1 million compared with a hypothetical loss of \$2.2 million, or a net loss in excess of \$1.1 million of the equity requirements. Had these 19 positions been required to maintain equity

in accordance to the requirements recommended by the Options Study described above the total equity requirement for these 19 positions would have been increased by \$900,000 to a total of \$2 million and accordingly the hypothetical loss not covered by equity requirements in these 19 positions would have been reduced from \$1.1 million to \$200,000.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS NET CAPITAL RULE TO INCREASE THE DEDUCTION IN COMPUTING NET CAPITAL FOR NEAR OR AT-THE-MONEY OPTIONS BY PROVIDING THAT THE DEDUCTIONS FOR SHORT OPTIONS POSITIONS IN MARKET MAKER ACCOUNTS BE EQUAL TO THE GREATER OF (i) 75 PERCENT OF THE PREMIUM VALUE, (ii) \$75, OR (iii) 5 PERCENT OF THE MARKET VALUE OF THE UNDERLYING STOCK REDUCED BY THE AMOUNT BY WHICH THE EXERCISE PRICE OF THE OPTION VARIES FROM THE CURRENT MARKET PRICE FOR THE STOCK.

c. Restriction on Volume of Business Carried

As explained above, the Commission's net capital rule requires a market maker clearing firm to reduce its net capital to the extent that the deductions required under the rule with regard to the positions in a market maker account (equity requirement) exceed the equity in that market maker account. The rule further provides that these gross deductions, calculated by the market maker clearing firm to determine the equity requirements in all of its market maker accounts, may not exceed 10 times its net capital for a period exceeding five consecutive business days. During these five business days, the market



maker clearing firm can increase its capital, or call upon its market makers to reduce their positions or deposit additional equity to reduce the direct deductions against the market maker clearing firm's net capital. This provision of the net capital rule was adopted to restrict the amount of options market maker business a clearing firm could conduct based on its level of capitalization. During the period just prior to April 14, 1978, all eight of the OCC member firms carrying most of the market maker accounts were in compliance with this provision and only two maintained ratios in excess of five times their net capital. These two carrying firms were the same firms that failed to comply with the Commission's net capital rule on April 17, 1978. If each of these firms had been required to maintain a ratio of deductions of less than five times its net capital prior to the April market surge, Firm A would have been required to have had additional capital of \$3,000,000, and Firm B would have been required to have had additional capital of \$700,000. Because of these findings, the Options Study believes that the currently allowable ratio of deductions to net capital permits OCC member firms to carry an excessive amount of market maker business and that this ratio should be reduced.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS  
NET CAPITAL RULE TO REDUCE THE PERMISSIBLE  
AMOUNTS OF GROSS DEDUCTIONS TO NET CAPITAL,

RESULTING FROM THE OPTIONS AND STOCK POSITIONS  
CARRIED BY A CLEARING FIRM FOR MARKET MAKERS.d. Market Maker Minimum Net Capital

The 1975 Amendments to the Exchange Act contemplated that the Commission would adopt financial responsibility requirements for all broker-dealers. Prior to the Commission's adoption of its net capital rule in 1975, broker-dealers which were subject to the financial requirements established by a national securities exchange were exempt from the Commission's financial requirements. When the Commission amended its net capital rule in 1975, all broker-dealers became subject to this rule except specialists, including market makers which did not carry customer accounts. In announcing the amendments to the net capital rule, the Commission stated:

The rule as adopted separately classifies stock exchange specialists who do not deal with other than members, brokers or dealers and certain specialists and market makers in options under specified circumstances and exempts such classes from the rule. The rules, settled practices and applicable regulatory procedures of the American Stock Exchange, Boston Stock Exchange, Midwest Stock Exchange, New York Stock Exchange, Pacific Stock Exchange, P&W Stock Exchange [Philadelphia Stock Exchange] and the Chicago Board Options Exchange are satisfactory to the Commission to permit the separate classification of such market makers and specialists and their exemption from the provisions of the rule.

It should be noted, however, that Section 15(c)(3) of Securities Exchange Act of 1934 ("the Act") requires the establishment of minimum financial responsibility requirements for all brokers and dealers. The application of financial responsibility requirements to specialists present unique questions which are still being explored by the Commission and while the alternative approach adopted today appears to be a possible solution to this question, the Commission believes further study is warranted. The Commission expects to conclude its review as promptly as practicable. 36/

In particular, the Commission noted in its release:

The rule requires specialists, market makers, and registered traders in options who either transact business with other than members, brokers or dealers or who are clearing members of the Options Clearing Corporation ("OCC") to comply with the basic provisions of the net capital rule as they relate to options. However, the rule will continue to classify separately and exempt market makers and specialists who are not clearing members of the OCC and who do not transact a business in securities with other than members, brokers and dealers. In that connection, the rule incorporates specific net capital treatment for brokers and dealers carrying the accounts of such options specialists, market makers, and registered traders. The Commission anticipates that market maker, specialist and registered trader capital requirements will be amended periodically to provide for modifications of those requirements as the option market may evolve. 37/

It has been argued that market makers would perform better and possibly more conservatively if their own capital were at stake in their transactions. It has also been contended that if market makers

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36/ Exchange Act Release No. 11497 (June 26, 1975).

37/ Exchange Act Release No. 11497 (June 26, 1975).

had a minimum capital requirement, they would be less dependent upon, and thereby less likely to be subject to the direction of, their clearing member. In September 1977, the Division of Market Regulation recommended to the Commission that it approve for public comment certain proposed amendments to the net capital rule which would have required those market makers that were exempt from the Commission's rule to maintain net capital of \$25,000.

This proposed rule was not published for comment, in part because the Commission lacked statistical data to determine its possible impact on the options market. The Options Study has since found that on March 31, 1978 (before losses were incurred during the April market surge), 498 of the 865 active market makers on all options exchanges had less than \$25,000 equity in their accounts. Of these, 279 had less than \$5,000 equity in their accounts.

An analysis by the Options Study and the CBOE of the market maker accounts carried by the two market maker clearing firms which experienced capital deficiencies under the Commission's net capital rule during the April market surge, did not indicate that a \$25,000 minimum financial responsibility standard need be required. The deficiencies experienced by Firm A and Firm B referred to above, were not caused by market maker accounts holding only small amounts of equity.

Firm A's adjusted net capital declined between April 13 and 17, 1978, by approximately \$7,000,000. At the time Firm A carried 173 market maker accounts. At Firm A, ten accounts caused almost \$5,000,000 of this decline; 15 accounts caused an aggregate decline of about \$5,750,000; and 20 accounts caused an aggregate decline of more than \$6,300,000 or approximately 87 per cent of the firm's net capital decrease between April 13 and 17. Of the ten accounts causing Firm A's greatest net capital decline, five had equity in excess of \$1,000,000 on April 12, four had equity in excess of \$250,000, and one had equity in excess of \$70,000. Accounts having an equity of \$100,000 or more on April 12 were the cause of more than 92 percent of the firm's net capital decline, and accounts with equity of less than \$25,000 were the cause of less than one percent of its decline.

Firm B's adjusted net capital declined between April 13 and 17, 1978, by approximately \$1,800,000 of which approximately \$1,300,000 was caused by ten accounts. All but two of the ten accounts had equity on April 12 in excess of \$25,000 and all but four in excess of \$50,000. For the firm as a whole, 70 percent of the net capital decline was caused by accounts having equity on April 12 in excess of \$25,000.

In view of the directives contained in the 1975 amendments to the Exchange Act, however, the Options Study believes that market makers should be required to have a minimum equity, similar to the amount required under the Commission's net capital rule for other broker-dealers not carrying public customer accounts, currently \$5,000. The Options

Study believes this requirement will add financial responsibility to the options market maker system without unnecessarily impeding entry into the business.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS  
NET CAPITAL RULE TO REQUIRE MARKET MAKERS  
THAT DO NOT CARRY CUSTOMER ACCOUNTS OR CLEAR  
TRANSACTIONS TO MAINTAIN A MINIMUM EQUITY OF  
\$5,000.

e. OCC Members and Their Affiliates that are Market Makers

In June 1977, the Commission's net capital rule was amended with respect to OCC members which limited their business to acting as market makers for their own accounts and to the carrying of the accounts of other market makers. <sup>38/</sup> As modified, the rule permits these firms to apply the same limited net capital deductions to their options and stock positions as those required to determine the market maker equity requirements for market makers accounts being cleared through an independent firm. Prior to this amendment, such positions were subject to the more stringent net capital deductions for options positions held by upstairs dealers. For example, an upstairs dealer is required to make a net capital deduction equal to 30 percent of the value of the underlying security on the sale of an uncovered option whereas a market maker is required to have equity of 75 percent of the premium value of a short option with a minimum of \$75 per options contract.

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<sup>38/</sup> Exchange Act Release No. 13623 (June 13, 1977).

The options and stock positions of the market makers carried by an independent firm are subject to arm's-length negotiated review which include; (1) hedge analysis; (2) review of the size of uncovered short positions; (3) net capital requirement impact; and (4) in some cases, the firm's knowledge of the ability of the market maker, as part of the firm's effort to protect its financial interest as a creditor of the market maker accounts it carries. This safeguard, however, is lacking when a clearing firm is trading in options on the floor of an exchange for its own account or is clearing an account in which an affiliated person has an ownership interest. A market maker clearing firm trading for its own account, or carrying an account in which an officer or partner or employee of the clearing firm has an ownership interest, may not apply the same day-to-day review and risk management techniques to such an account as would normally be applied to an independent market maker account.

The Options Study has learned of instances in which a principal officer of a clearing firm has a direct ownership interest in market maker accounts. In one instance, the market maker account would have had a liquidating deficit without the principal officer's contribution to the account. Another example involved a market maker clearing firm which maintained an approximate one-third interest in a market maker account. When this account caused a \$3.7 million deduction in computing the market maker clearing firm's net capital, resulting in a net capital deficiency of about \$480,000, it became necessary to liquidate the account

to eliminate the net capital deficiency. It is questionable whether an independent OCC member firm would have been willing to carry the positions that resulted in a loss of this magnitude.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS NET CAPITAL RULE SO THAT THE CAPITAL REQUIRED FOR ALL OF THE POSITIONS IN AN ACCOUNT IN WHICH A CLEARING FIRM, ITS OFFICERS, PARTNERS, DIRECTORS OR EMPLOYEES MAINTAIN A FINANCIAL INTEREST ARE INCREASED. THIS MAY BE ACCOMPLISHED BY REQUIRING THAT SUCH ACCOUNTS MEET THE SAME FINANCIAL REQUIREMENTS THAT ARE APPLICABLE TO UPSTAIRS DEALER FIRMS.

f. Immediate Charges to Carrying Firm Under the Net Capital Rule

The net capital deductions that result from stock and options transactions in market maker accounts carried by a market maker clearing firm must be made on the same day the transactions occur although these transactions do not clear until the next day. While this requirement was adopted in recognition that options transactions clear the next business day, it results in a market maker clearing firm having to maintain a net capital position in anticipation of these charges and can impose a significant burden on the market maker clearing firm. For example, during the April market surge the total charges to market maker clearing firm net capital increased from an aggregate of \$12.3 million on April 13, 1978 to \$21 million on April 17 and then dropped back to \$15.8 million on April 18, and \$11.6 million by April 24, 1978. 39/

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39/ Table No. 7 appended as Exhibit 6.



Usually, the net capital deduction for other securities transactions by broker-dealers is not made until the day the transaction normally clears ("settlement date"). For example, no charge is made to net capital on the purchase of a stock by a broker-dealer until the settlement date, generally, five business days after the purchase. The Options Study believes that market maker clearing firms should have until the next business day after their market maker transactions occur — the day the transactions normally clear — to put additional capital into the firm or to obtain additional capital from market makers whose accounts they carry. This change in the net capital rule would not relieve a market maker which does not clear his own transactions from his responsibility to have equity in his account at the end of each day.

While this recommended change may have the effect of reducing the amount of net capital market maker clearing firms must maintain on a regular basis, other recommendations of the Options Study described above will increase their net capital requirements and affect the timing of net capital deductions to make them more sensitive to particular options risks.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONSIDER REVISING ITS NET CAPITAL RULE TO PERMIT A MARKET MAKER CLEARING FIRM ONE BUSINESS DAY TO OBTAIN ADDITIONAL CAPITAL OR MARKET MAKER EQUITY BEFORE MEETING THE NET CAPITAL DEDUCTIONS ARISING OUT OF ITS MARKET MAKER CLEARING BUSINESS.