regulatory organizations of which the broker or dealer is a member.

(B) Each index must be duplicated and the duplicate copies must be stored separately from the original copy of each index.

(C) Original and duplicate indexes must be preserved for the time required for the indexed records.

(v) The member, broker, or dealer must have in place an audit system providing for accountability regarding inputting of records required to be maintained and preserved pursuant to §§ 240.17a–3 and 240.17a–4 to electronic storage media and inputting of any changes made to every original and duplicate record maintained and preserved thereby.

(A) At all times, a member, broker, or dealer must be able to have the results of such audit system available for examination by the staffs of the Commission and the self-regulatory organizations of which the broker or dealer is a member.

(B) The audit results must be preserved for the time required for the audited records.

(vi) The member, broker, or dealer must maintain, keep current, and provide promptly upon request by the staffs of the Commission or the self-regulatory organizations of which the member, broker, or broker-dealer is a member all information necessary to access records and indexes stored on the electronic storage media; or place in escrow and keep current a copy of the physical and logical file format of the electronic storage media, the field format of all different information types written on the electronic storage media and the source code, together with the appropriate documentation and information necessary to access records and indexes.

(vii) For every member, broker, or dealer exclusively using electronic storage media for some or all of its record preservation under this section, at least one third party (''the undersigned''), who has access to and the ability to download information from the member's, broker's, or dealer's electronic storage media to any acceptable medium under this section, shall file with the designated examining authority for the member, broker, or dealer the following undertakings with respect to such records:

The undersigned hereby undertakes to furnish promptly to the U.S. Securities and Exchange Commission (''Commission''), its designees or representatives, upon reasonable request, such information as is deemed necessary by the Commission's or designee's staff to download information kept on the broker's or dealer's electronic storage media to any medium acceptable under Rule 17a–4.

Furthermore, the undersigned hereby undertakes to take reasonable steps to provide access to information contained on the broker's or dealer's electronic storage media, including, as appropriate, arrangements for the downloading of any record required to be maintained and preserved by the broker or dealer pursuant to Rules 17a–3 and 17a–4 under the Securities Exchange Act of 1934 in a format acceptable to the Commission's staff or its designee. Such arrangements will provide specifically that in the event of a failure on the part of a broker or dealer to download the record into a readable format and after reasonable notice to the broker or dealer, upon being provided with the appropriate electronic storage medium, the undersigned will undertake to do so, as the Commission's staff or its designee may request.

* * * * *

By the Commission.

Dated: February 5, 1997.

Margaret H. McFarland,

Deputy Secretary.

Note: Appendix A to the Preamble will not appear in the Code of Federal Regulations.

Appendix A—Regulatory Flexibility Act Certification

I, Arthur Levitt, Chairman of the Securities and Exchange Commission, hereby certify pursuant to 5 U.S.C. 605(b) that the final amendments to Rule 17a–4 set forth in Securities Exchange Release No. 34–38245 will not have a significant economic impact on a substantial number of small entities. Specifically, the amendments do not alter the regulatory requirements for broker-dealers using currently accepted media for record retention purposes (i.e., paper, microfilm, or microfiche). Instead, the amendments expand the record retention media options by allowing broker-dealers to utilize certain electronic storage media to store records required under 17 CFR 240.17a–3 and 240.17a–4. Accordingly, the amendments will not change the impact of current regulatory record preservation requirements on a substantial number of small entities.

Dated: January 31, 1997.

Arthur Levitt,

Chairman.

[FR Doc. 97–3426 Filed 2–11–97; 8:45 am]

BILLING CODE 8010–01–P

---

17 CFR Part 240

[Release No. 34–38248; File No. S7–7–94]

RIN 3235–AG14

Net Capital Rule

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is amending Rule 15c3–1 under the Securities Exchange Act of 1934 (''Exchange Act''), the net capital rule, to permit broker-dealers to employ theoretical option pricing models in determining net capital requirements for listed options and related positions. Alternatively, broker-dealers may elect a strategy-based methodology. The amendments are intended to simplify the net capital rule's treatment of options for capital purposes and more accurately reflect the risk inherent in broker-dealer options positions.

EFFECTIVE DATE: The amendments become effective September 1, 1997.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director (202) 942–0131, Peter R. Geraghty, Assistant Director (202) 942–0177, or Louis A. Randazzo, Special Counsel (202) 942–0191, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5–1, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Commission is adopting amendments to Rule 15c3–1 under the Exchange Act to permit broker-dealers to employ theoretical option pricing models to calculate required net capital for listed options and the related positions that hedge those options. In adopting these amendments, the Commission is continuing its process of revising the net capital rule that was contemplated when the Commission solicited comments on a range of capital related issues in 1993.[1] The amendments being adopted today were proposed in initial form in March of 1994 and would allow broker-dealers to use an options pricing model to determine capital charges for listed options and related positions.[2] Simultaneously with the Commission's proposal, the Division of Market Regulation (''Division'') issued a no-action letter allowing broker-dealers to utilize the options pricing approach immediately.[3] Based on the experience gained by the Commission under the no-action letter, and the nature of the comments received during the public comment period, the Commission is

[1] Securities Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486 (May 10, 1993) (''Concept Release'').

[2] Securities Exchange Act Release No. 33761 (March 15, 1994), 59 FR 13275 (March 21, 1994) (''Proposing Release'').

[3] Letter from Brandon Becker, Division of Market Regulation, SEC to Mary L. Bender, First Vice President, CBOE and Timothy Hinkas, Vice President, The Options Clearing Corporation (''OCC'') (March 15, 1994) (''1994 No-Action Letter'').

adopting the proposed amendments with certain changes discussed herein. The rules will become effective on September 1, 1997; however, broker-dealers that desire to apply the rule before the effective date may do so.

A. The Net Capital Rule Generally

The Commission adopted its first net capital rule in 1942.[4] The rule requires that every registered broker-dealer maintain certain specified minimum levels of net capital. The primary purpose of the rule is to protect the customers of a broker-dealer from losses that can be incurred upon the broker-dealer's failure. Rule 15c3–1 requires registered broker-dealers to maintain sufficient liquid assets to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal legal proceeding. The rule prescribes different required minimum levels based upon both the method a firm adopts in computing its net capital and the type of securities business it conducts. A firm engaging in a general securities business (which would allow the firm to clear and carry customer accounts) must maintain a minimum net capital level of the greater of $250,000 or 6⅔ percent of its liabilities (with certain exclusions), or if the firm chooses the alternative method, the greater of $250,000 or 2 percent of its customer-related receivables. The different minimum levels of net capital for firms based on categories of business activity are designed to address the perceived risk in the broker-dealers' business. For example, if a broker-dealer carries no customer accounts and does not engage in certain specified activities, it can maintain as little as $5,000 in net capital.

Under the net capital rule, a broker-dealer takes its net worth, computed in accordance with generally accepted accounting principles, deducts certain illiquid assets (such as goodwill), certain percentages from its proprietary securities or commodities inventory, and adds back certain liabilities to arrive at net capital. This number is then compared to its requirement to determine compliance. Much of the rule itself is comprised of the haircut deductions which account for the market and other risks inherent in a trading business. The Commission believes the net capital rule has performed its customer protection function well over the years, has enabled the Commission and the self-regulatory organizations (''SROs'') to identify financial problems at early stages, and has allowed the Commission and the SROs to perform self-liquidations of failing securities firms without both customer loss and the need for proceedings under the Securities Investor Protection Act of 1970.[5]

Currently, the net capital rule provides two basic capital treatments for option positions held by broker-dealers. The first approach, which is set forth in Appendix A to Rule 15c3–1, was designed for firms clearing their proprietary listed option and related positions, and assumes that the option will be exercised or held to expiration. The second approach, which is set forth in Rule 15c3–1(c)(2)(x), is a premium-based approach. Both methodologies of computing charges provide for lower haircuts for certain risk offsetting positions held by broker-dealers, although the premium-based approach recognizes more types of offsetting positions and gives value for the portion of the premium which is related to time.

B. The Development of the Options Pricing Approach to Capital

In 1973, Fischer Black and Myron Scholes introduced a formula to calculate the value of European style options. The Black-Scholes formula assumes that the primary factors affecting the price of an option are: the value of the underlying asset, the exercise price of the option, the volatility of the underlying asset, the risk-free rate of interest, and the remaining time to expiration. Subsequent to the development of the Black-Scholes formula, the Cox-Ross-Rubinstein binomial pricing formula was developed. By calculating different probable option values at various intervals, the formula is able to more easily incorporate dividends, the term structure of the yield curve, and the early exercise feature of American style options. Other models which are based on the Cox-Ross-Rubinstein formula have since been developed, including OCC's Theoretical Intermarket Margining System (''TIMS''), which is used to measure the market risk associated with participants' positions and to establish clearing house margin requirements.

The sharp market breaks in 1987 and 1989 made it imperative for the Commission to review the adequacy of the current options haircut methodology. The Chicago Board Options Exchange (''CBOE'') and OCC formed a task force to determine whether a more rigorous and predictive approach to haircuts could be developed. As noted, the current methodology requires that positions be allocated to specific recognized strategies which are then haircut at the prescribed levels. The aggregate haircut for a class, or product group in the case of indexes, is the sum of the haircuts calculated for each individually identified strategy. CBOE and OCC believed that the current strategy-based approach did not effectively recognize the risk reduction of offsetting positions within a class or product group, and therefore such approach required excessive amounts of capital to maintain such offsetting positions. In addition, CBOE and OCC maintained that the haircuts associated with short, unhedged, out-of-the-money options were an insufficient measure of capital adequacy with respect to rapid, material changes in market prices. At that time, OCC had been utilizing an options pricing model to establish clearing house margin requirements. In addition, traders and risk managers had been using options pricing models in the development of trading strategies and the management of market risk. Thus, the task force determined to explore the impact of haircuts calculated through the use of an options pricing model.

CBOE and OCC conducted a preliminary study which compared haircut and account equity data obtained from three options market-maker clearing firms with position risk calculated using a derivation of TIMS for a three month time frame in late 1990. Current haircuts and equity were compared to the maximum loss under TIMS per class or product group for each market-maker account. The preliminary study disclosed that haircuts would be reduced for well-hedged, strategy-diverse positions, and increased for unhedged positions. The study further disclosed that the subject clearing firms maintained sufficient capital to continue in capital compliance under the new approach. Based upon the results of this study, the Division invited CBOE and OCC to propose a formal pilot program specifically designed for calculating haircuts for listed options on currencies, equities, and securities and futures indexes.

The Division, CBOE, and OCC agreed upon the criteria to be used in the pilot program, and OCC staff developed the software and performed the operations

[4] The section 8(b) of the Securities Exchange Act that was adopted in 1934 contained a rudimentary net capital ratio requirement for members of national securities exchanges and broker-dealers conducting business through members. In 1942, the Commission adopted its first net capital rule. Section 8(b) was repealed by section 5(2) of the Securities Act Amendments of 1975, which also required the adoption of the uniform net capital rule applicable to all broker-dealers.

[5] 15 U.S.C. 78aaa *et seq.*

to calculate the risk-based haircuts. TIMS was used to project prices. Projected price moves were calculated based upon the closing underlying asset price for each day plus and minus moves at ten equidistant data points over a range of market movements. The greatest loss at any one of these points would become the haircut. The volatility implied from the closing price of the options series was used for the calculation of each projected price for that series. To account for liquidation risk, a minimum charge of ⅛ point per option contract was applied when the haircut for the class or product group reflected little or no market exposure.

The results of the pilot program were consistent with earlier findings in that accounts having primarily hedged positions reflected significant haircut reductions; unhedged portfolios received higher capital charges. Based in part on this experience, the Commission issued the Proposing Release for comment.

C. The Commission's Proposal

The proposed amendments provided that, with respect to each option series[6] it clears, OCC would collect certain information on a daily basis.[7] Using this information and TIMS, OCC would measure the implied volatility for each option series. After measuring the implied volatility for each option series, OCC would input to the model the resulting implied volatility for each option series. For each option series, the model would calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or a decrease of the following percentages of the daily market price of the underlying instrument:

(i) +(−) 15% for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes,[8]

(ii) +(−) 6% for major market currencies,[9]

(iii) +(−) 10% for high-capitalization diversified indexes,[10] and

(iv) +(−) 20% for currencies other than major market currencies.

After the model calculated the theoretical gain/loss valuations, OCC would provide the valuations to broker-dealers. Broker-dealers would download this information into a spreadsheet from which the broker-dealer would calculate the profit/loss for each of its proprietary and market-maker options positions.[11] The greatest loss at any one valuation point would be the haircut.[12]

Depending upon the type of positions a broker-dealer sought to offset, a percentage of a position's gain at any one valuation point would offset another position's loss at the same valuation point. The proposed amendments allowed the following offsets: (1) within any portfolio type involving the same underlying stock, index, or currency, 100% of a position's gain at any one valuation point would offset another position's loss at the same valuation point; (2) between qualified stock baskets (provided the stock basket represented no less than 90% of a high-capitalization diversified index's capitalization or 100% of the capitalization of a narrow diversified index) offset by index options, or futures, or futures options on the same underlying index, 95% of gains would offset losses at the same valuation point; (3) among high-capitalization diversified index options, futures, and futures options, 90% of the gain on one high-capitalization index position in the same product group would offset the loss on a position on a different high-capitalization diversified index at the same valuation point; and (4) among non-high-capitalization diversified index options, futures, and futures options, 75% of the gain on one non-high-capitalization diversified index position would offset the loss on a different non-high-capitalization diversified index at the same valuation point.

Under the proposed amendments, required deductions were: (1) the amount of losses at any of the 10 equidistant valuation points representing the largest theoretical loss after applying the permissible offsets; or (2) a minimum charge equal to ¼ of a point[13] times the multiplier for each options contract (or $25.00 per option contract assuming that option contract covers 100 shares) and each related instrument within the option's class or product group, or $25 for each option on a major market foreign currency; plus (3) in the case of portfolio types involving index options and related instruments offset by a qualified stock basket, a minimum charge of 5% of the market value of the qualified stock basket for high-capitalization indexes, whether diversified or narrow-based; or (4) in the case of portfolio types involving index options and related instruments offset by a qualified stock basket, a minimum charge of 10% of the market value of the qualified stock basket for diversified non-high-capitalization indexes.

In proposing the amendments, the Commission recognized that certain broker-dealers may not want to, or may not find it cost effective to use an options pricing methodology because of their limited dealings in options. Accordingly, the proposed amendments also included an alternative strategy-based haircut methodology that generally followed, but was more limited than, the haircut approach embodied in the current rule.

Under the current rule, a broker-dealer that carries accounts of listed options specialists must take a charge against capital as of the close of business each day even though the broker-dealer does not know the level of the charges until the following day. The proposed amendments provided broker-

[6] An option series includes option contracts of the same type (either a call or a put) and exercise style covering the same underlying instrument with the same exercise price, expiration date, and number of underlying units. The Commission notes that for the purposes of the final amendments, the term listed option includes listed warrants.

[7] Under the proposed rule, OCC would collect the following information: (1) the dividend streams for the underlying securities, (2) interest rates (either the current call rate or the Eurodollar rate for the maturity date which approximates the expiration date of the option), (3) days to expiration, and (4) closing underlying security and option prices from various vendors.

[8] In order to avoid confusion with the designation of indexes for margin or futures eligibility, the final amendments and the remainder of this release refer to ''broad-based'' indexes as ''diversified'' indexes.

[9] The major market currencies are: Deutsche Mark, British Pound, Swiss Franc, French Franc, Canadian Dollar, Japanese Yen and European Currency Unit.

[10] The Commission indicated in the Proposing Release that underlying price movement assumptions for the proposed theoretical pricing model should be consistent with the volatility assumptions currently incorporated in the net capital rule.

[11] For those broker-dealers which choose to use TIMS but do not obtain a computer interface with OCC, OCC has developed a dial-up service by which such broker-dealers may obtain, on a daily basis, theoretical gains and losses. Other third-party vendors would presumably offer a similar service. Any such dial-up service may be a more practical option for those broker-dealers that do not find it economically feasible to maintain a computerized interface with a third-party source, but that do not wish to apply the alternative strategy-based methodology, as discussed below.

[12] The spreadsheet would be programmed to compute a minimum haircut charge and identify the greater of the computed or minimum charge as the haircut. For example, assume a portfolio consisting of IBM common stock and various puts and calls on IBM common stock with different strikes and expiration dates. OCC would re-price each option position assuming that the price of the IBM common stock had moved up or down by a maximum of 15%, at 10 valuation points (*i.e.*, −15%, −12%, −9%, −6%, −3%, +3%, +6%, +9%, +12%, +15%). The single, maximum net loss amount at any one of the 10 valuation points would become the haircut for the portfolio.

[13] As noted earlier, the pilot program applied a minimum haircut of ⅛ of a point. Pursuant to a recommendation by CBOE and OCC, the Proposing Release increased the minimum charge to ¼ of a point per option contract. The Commission believed this increase was appropriate to account for liquidation and decay risk in options prices in situations where application of the proposed amendments resulted in little or no charge.

dealers with additional time by which to take the capital charge. Specifically, the proposed amendments provided that broker-dealers could adjust their net worth by deducting as of noon of the next business day the charges computed as of the prior business day. In addition, the proposed amendments provided that the required deductions could be reduced by the deposit of funds or securities by noon of the next business day.

D. Summary of Comments

The Commission received ten comment letters in response to the Proposing Release.[14] The comments, in general, were supportive of the Commission's proposal. Most commenters, however, suggested that, in addition to TIMS, the Commission permit the use of other pricing models.[15] In addition, some commenters suggested that the Commission allow the use of theoretical pricing models in connection with over-the-counter (''OTC'') options and positions in U.S. Treasury securities.

The commenters also suggested that the underlying price assumption for high-capitalization diversified indexes be reduced and that the rule permit implied volatility inputs to fluctuate within certain parameters. In addition, a few commenters suggested that the minimum charge of ¼ of a point per option contract be reduced. These issues, as well as others, are discussed below.

II. Description of Rule Amendments

A. Use of TIMS Versus Other Pricing Models

In the Proposing Release and under the 1994 No-Action Letter, broker-dealers were required to use the OCC TIMS system as the exclusive means of determining theoretical options prices. While TIMS is a theoretically sound options pricing methodology, it is not the only recognized methodology in the marketplace. Other models, using different formulae, are also capable of arriving at legitimate results. In response to the comments and based on additional experience with models, the Commission is removing the requirement that TIMS be used. The final rule permits the use of a model (other than a proprietary model) maintained and operated by any third-party source and approved by an examining authority designated pursuant to Section 17(d) of the Exchange Act (''DEA''). The DEA shall submit to the Commission for consideration a description of its methods for approving models.[16] The model must consider at a minimum the following factors in pricing the option: (1) the current spot price of the underlying asset; (2) the exercise price of the option; (3) the remaining time until the option's expiration; (4) the volatility of the underlying asset; (5) any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and (6) current information about interest rates. Any such approval of a model by a DEA must include appropriate provisions relating to the obligations of the third-party vendor to supply timely and accurate information to the broker-dealers. Once a model has been approved by a DEA, broker-dealers may use the model in order to calculate haircuts. For purposes of this rule, the TIMS system as operated by OCC will be deemed to be an approved model for a period of two years from the effective date of these amendments. OCC, however, should clarify its vendor status by appropriate DEA approval.

In addition to the commenters' suggestions that the final amendments permit broker-dealers to utilize theoretical pricing systems other than TIMS, certain commenters argued that the Commission should permit the use of internal proprietary models for both listed products and OTC options. The staff of the Division is preparing a separate release which will propose for comment further amendments to the net capital rule to permit the use of proprietary models to value listed options.

B. Implied Volatilities

The TIMS model uses implied options volatilities to calculate theoretical prices of options. It was suggested that because TIMS does not alter implied volatilities as the theoretical price of the option changes, the model overlooks an important element that could have a major effect on capital requirements. In fact, requiring alteration of the implied volatilities would cause numerous additional computations without substantial benefits given the wide range in assumed underlying price movements. The Commission notes, however, that the amendments have been liberalized and permit the use of differing options pricing models. The properties of each model can then be evaluated during the model approval process established in the amendments.

C. Underlying Price Movement Assumptions

The proposed amendments included underlying price movement assumptions for the theoretical pricing model that are consistent with the volatility assumptions currently incorporated in the net capital rule. The Commission believes that requiring the model to ''shock'' the portfolio in the amounts currently incorporated into the net capital rule is necessary to ensure consistent treatment of options and the underlying positions. Since the amendments permit broker-dealers to take haircuts on equities after taking into consideration options on those equities, broker-dealers with limited options positions might seek to apply the assumptions to all of their positions (both equities and options) if the options pricing amendments utilized assumptions that were less robust than those currently in the net capital rule for the underlying positions. If this were the case, broker-dealers could potentially obtain more favorable treatment on their equity positions than currently contemplated by the net capital rule.

The Commission notes that the 1994 No-Action Letter contained a reduction in the underlying price movements for non-clearing specialists and market-makers to +(−)4½% for major market foreign currency positions, +(−)10% for non-high-capitalization diversified indexes, and +6(−8)% for high-capitalization diversified indexes. In that letter, the Division expressly declined to extend this position to other broker-dealers.[17] The concession for market-makers and non-clearing specialists was based upon the important role that non-clearing specialists and market-makers perform in maintaining fair and orderly markets. The Commission is incorporating the reduced requirements for market-makers into the final rule in light of these considerations, however, this concession expires two years from the effective date of the amendments unless

[14] The comment letters are available for public inspection and copying in the Commission's public reference room located at 450 Fifth Street, N.W., Washington, D.C. 20549 (File No. S7–7–94).

[15] Some commenters suggested the use of broker-dealer proprietary models or the Chicago Mercantile Exchange's Standard Portfolio Analysis System (''SPAN'') which is used by many futures exchanges to calculate margin requirements. Letter from Jeffrey Bernstein, Chairman, Capital Committee of the Securities Industry Association (''SIA'') to Jonathan G. Katz, Secretary, SEC (September 16, 1994), and Letter from Thomas R. Donovan, President and Chief Executive Officer, Chicago Board of Trade to Jonathan G. Katz, Secretary, SEC (May 13, 1994).

[16] The Commission notes that any such third-party source, including OCC, may charge broker-dealers a fee for the services they provide in connection with these amendments.

[17] *See* 1994 No-Action Letter, *supra* note 3, at note 5.

it can be demonstrated by the non-clearing specialists and market-makers that retention of reduced capital requirements is in the public interest. Therefore, the Commission is adopting the minimum price movements substantially as proposed.

Similarly, some commenters suggested that the +(−)10% price move assumption for high-capitalization diversified indexes (such as the S&P 500) was too high and should be reduced. During the time the 1994 No-Action Letter has been in effect using a +(−)10% assumption, there does not appear to have been any evidence of liquidity or execution problems in the option markets from application of this assumption. The Commission notes that this assumption is intended to cover the risks of uncovered, out-of-the-money option positions. Accordingly, the amendment retains the +(−)10% underlying assumption for high-capitalization diversified indexes.

D. Permissible Offsets

The proposed amendments permitted specified offsets between differing categories of instruments. The rule being adopted today maintains the concept of specifying offsets, but with a few significant changes. With respect to the offset between qualified stock baskets, the Commission received one comment which contended that rather than requiring that a basket contain a certain minimum amount of stock to be considered a qualified stock basket, the rule should permit a broker-dealer to convert every basket into a qualified stock basket by taking a haircut on the missing or excess stocks, depending on whether too little or too much of a stock was in the basket.

The Commission believes that the better approach is to maintain the stock basket capitalization requirement. The purpose of the minimum capitalization requirement is to ensure that a broker-dealer has a sufficient number of stocks that match those in the index so that the stocks correlate with the index. The Commission, however, believes that a decrease in the capitalization requirement is appropriate. Accordingly, under the rule amendment, to be a qualified stock basket, the basket must represent no less than 50% of a diversified index's capitalization and, for a narrow-based index, the basket must represent no less than 95% capitalization. The proposed amendments allowed offsets only between the same type of indexes and related positions. Commenters suggested that offsets be allowed between different diversified index product groups, and the Commission agrees it is appropriate to permit offsets for positions among different diversified index product groups. The groupings and netting allowances are set forth below.

In addition, questions have arisen regarding the methodology that should be used to designate indexes as high-capitalization diversified or non-high capitalization diversified for purposes of the rule. Set forth below is a list of those indexes which are to be treated as high capitalization diversified or non-high capitalization diversified, and the appropriate offsets. The offsets designated in the groupings are based on historical correlations. The Commission recognizes that this approach does not provide for the treatment of new indexes, however, the Commission intends to issue a release which will set forth generic guidelines for adding and deleting indexes (and designating appropriate offsets) for purposes of the net capital rule.

- U.S. Market Group A (i) Institutional Index (''XII''), (ii) Major Market Index (''XMI''), (iii) S&P 100 Index (''OEX''), (iv) S&P 500 Index (''SPX''), (v) New York Stock Exchange Composite Index (''NYA''), (vi) Big-Cap Sector Index (''MKT''), and (vii) PHLX US Top 100 Index (''TPX''). A 90% offset is permitted between classes within this product group, an 85% offset with U.S. Market Group B, and a 50% offset with the non-high capitalization diversified U.S. Market Product Group and the U.S. NASD Market Group.
- U.S. Market Group B (i) S&P Barra Growth Index, and (ii) S&P Barra Value Index. An 80% offset is permitted within this product group, an 85% offset with U.S. Market Group A, and a 50% offset with the non-high capitalization diversified U.S. Market Product Group and the U.S. NASD Market Group.
- Japan Market Group A (i) Japan Index (''JPN''), (ii) CBOE Nikkei 300 Index (''NIK''), and (iii) the Nikkei 225 Index (''NK''). A 90% offset is permitted within this product group.
- Japan Market Group B consists of the CBOE Japanese Export Warrant Index.
- European Market Product Group consists of the EuroTop 100 Index (''TOP'').
- United Kingdom Market Product Group consists of the Financial Times Exchange Index (''FT–SE'').

The following indexes are designated non high-capitalization diversified market indexes:

- U.S. Market Product Group (i) MidCap Index (''MID''), (ii) Russell 2000 Index (''RUT''), (iii) Value Line Index (''VLE''), (iv) Wilshire 250 Index (''WSX''), and (v) the S&P 600 Smallcap Index (''SML''). A 75% offset is permitted within this product group, and a 50% offset with the U.S. NASD Market Group and with high-capitalization diversified U.S. Market Groups A and B.
- U.S. NASD Market Group (i) NASDAQ 100 Index (''NDX''), and (ii) National OTC Index (''XOC''). A 75% offset is permitted within this product group and a 50% offset with the U.S. Market Product Group and with high-capitalization diversified U.S. Market Groups A and B.
- Mexican Market Product Group consists of the Index of Prices and Quotations (''IPC'').

The following indexes are designated narrow-based index options within the following sector product groups.

- Bank Sector Product Group (i) S&P Banking Index (''BIX''), and (ii) PHLX KBW Bank Index (''BKX''). A 90% offset is permitted within this product group.
- Technology Sector Product Group (i) Morgan Stanley High Tech 35 Index (''MSH''), (ii) PSE Technology Index (''PSE''), (iii) CBOE Technology Index (''TXX''), (iv) AMEX Computer Technology Index (''XCI''), (v) Goldman Sachs Technology Index (''GSTI'') Composit Index (''GTC''), (vi) GSTI Hardware Index (''GHA''), (vii) GSTI Multimedia Network Index (''GIP''), and (viii) GSTI Software Index (''GSO''). A 75% offset is permitted within this group. In addition, the PSE may be offset 75% with the U.S. NASD Market Group.
- Internet Product Group (i) CBOE Internet Index, (ii) AMEX Internet Index, and (iii) GSTI Internet Index (''GIN''). A 75% offset is permitted within this group.
- Oil Product Group (i) CBOE Oil Index (''OIX''), and (ii) AMEX Oil and Gas Index (''XOI''). A 90% offset is permitted within this product group.
- Gold Product Group (i) CBOE Gold Index (''GOX''), and (ii) PHLX Gold/Silver Index (''XAU''). A 90% offset is permitted within this product group.
- Semiconductor Product Group (i) PHLX Semiconductor Index (''SOX''), and (ii) GSTI Semiconductor Index (''GSM''). A 90% offset is permitted within this product group.
- Semiconductor Product Group (General) All remaining narrow-based indexes. No offset is permitted within this product group.

E. Minimum Charges

The minimum charge specified in the rule is designed to account for liquidation and decay risk in the prices of long and short options in those

instances in which applications of the theoretical pricing methodology results in little or no capital requirement. One commenter noted that the use of a minimum charge of a ¼ of a point was a fair method of estimating the liquidation risk of out-of-the-money options. Another commenter indicated that the impact of the minimum charge was to cause spreads for out-of-the-money calls and puts to expand because market-makers are reluctant to sell these options.

Thus far, there is no evidence that these concerns have been borne out, however, the Commission intends to monitor the impact of the amendments and whether these concerns arise in fact. In the meantime, the Commission believes that the minimum charge should be retained as proposed. The rule as adopted, therefore, requires a minimum charge of ¼ of a point or $25.00 per option contract assuming that the basic equity option contract covers 100 shares. To the extent that an option or futures contract exceeds the size of a basic option contract, the minimum charge will be increased by the additional percentage amount of underlying units. For example, an option or a futures contract on the S&P 500 Index covers 500 shares (rather than 100 shares for a basic equity option contract) and therefore the minimum charge would be $125.00 (5×$25.00).

In addition to the ¼ of a point minimum charge, the proposed amendments required an additional deduction of 10% for each qualified stock basket of non-high-capitalization diversified indexes, and 5% for each qualified stock basket of high-capitalization diversified and narrow-based indexes for those positions hedging an options or futures contract subject to the minimum charge. In response to concerns that, in the case of non-high-capitalization indexes, the 10% charge was excessive, the Commission believes it is appropriate to decrease this charge to 7.5%. For high-capitalization indexes, the proposed 5% charge will be adopted.

F. Alternative Strategy-Based Methodology

The proposed amendments provided that broker-dealers could elect to use the alternative strategy-based method for calculating haircuts. One commenter contended that the alternative strategy-based methodology contained in the proposal, because it contained very few simple strategies, would impose haircuts on a trading book which are larger than the haircuts in the current rule. The commenter recommended that the Commission explore the possibility of adopting a strategy-based calculation that would include common strategies currently used by firms.

The Commission notes that the new rule is designed in part to eliminate the complicated overlay of strategies and interpretations that developed out of the necessity to accommodate all dealer options strategies. To attempt to recognize many classes of strategies in the alternative section would result in a return to the system the Commission is revising today. Hence, the Commission believes that a simple strategy-based alternative should be retained in the rule. Limiting the alternative to simple strategies will tend to encourage firms with any options positions of substance to utilize the pricing model methodology. Because the recognized strategies in the alternative section are minimal, limited hedges will be recognized with the result that a book of any significance will incur larger charges under the strategy-based method than the options pricing methodology. This will provide an economic incentive for firms active in options to develop the capability to use up-to-date modelling techniques.

G. Clearing Firm Capital Deposits

The net capital rule requires broker-dealers carrying the accounts of listed options specialists to take capital charges reflecting haircuts required due to specialists' trading activity. The capital rule historically has required the clearing firm to take the required charge as of the close of business each day to ensure it has sufficient capital to open the next morning. However, the carrying firm generally will not know the full extent of its requirements as to its specialists until that next morning. Generally, clearing firms will seek to bring in money, either from the specialist or from elsewhere during the morning. This is a conservative charge considering the rule's usual acceptance of allowing time for margin calls. To remedy this, the proposal allowed the clearing firm until noon to obtain funds or arrange financing. All of the commenters who addressed the issue supported it; accordingly, the Commission is adopting the provision with the clarification that ''noon'' is determined according to the local time where the carrying firm has its headquarters. In any event, this provision will not be available for a market-maker account in deficit.

III. Technical Amendments to the Rule

As noted in the Proposing Release, in connection with the adoption of the amendments, the Commission is making the following technical amendments to the net capital rule necessitated by the new amendments and to codify a long-standing staff interpretation:

A. Deletion of Paragraph (a)(7) of the Net Capital Rule

As previously stated, the net capital rule, as it currently is written, contains two haircut methodologies, the premium-based approach set forth in Rule 15c3–1(c)(2)(x) and the approach embodied in Appendix A to Rule 15c3–1. Currently, pursuant to the provisions of paragraph (a)(7) of the net capital rule, the premium-based approach is available to a clearing firm if its business is limited almost exclusively to effecting (either directly or as agent) and clearing market-making transactions in listed options.

The final rule deletes paragraph (a)(7) of the net capital rule. The Commission believes that this provision is no longer necessary because the final rule eliminates the distinction between the premium-based approach set forth in 15c3–1(c)(2)(x) and the approach set forth in Appendix A to 17 CFR 240.15c3–1.

B. Steps To Be Taken by a Broker-Dealer Carrying the Account of an Option Market-Maker When Equity in That Account is Insufficient to Cover Haircuts

Pursuant to an interpretation letter,[18] carrying broker-dealers may extend credit in a market-maker account even when haircuts for that account exceed the equity in the account.[19] This interpretation is conditioned upon the carrying broker-dealer taking a charge against its capital to the extent that the equity in the market-maker's account is insufficient to cover the haircuts. The amendments incorporate this interpretation into the net capital rule.

IV. Summary of the Final Regulatory Flexibility Analysis

The Regulatory Flexibility Act, which became effective on January 1, 1981, imposes procedural steps applicable to agency rule making which has a ''significant economic impact on a substantial number of small entities.'' [20]

[18] Letter from Lee A. Pickard, Director, Division of Market Regulation, SEC, to Joseph W. Sullivan, President, CBOE (April 8, 1977).

[19] Currently, paragraph (c)(2)(x)(F) of Rule 15c3–1 provides that, if the haircuts for a particular market-maker's account exceed the equity in the account, the carrying broker-dealer may not extend further credit to the market-maker unless the carrying broker-dealer requires the additional deposit of sufficient equity to eliminate the net capital charge.

[20] Although Section 601(b) of the Regulatory Flexibility Act defines the term ''small entity,'' the

Continued

The Commission has prepared a Final Regulatory Flexibility Analysis (''Analysis'') in accordance with 5 U.S.C. § 604 regarding the amendments. The Analysis states that the Commission did not receive any comments concerning the Initial Regulatory Flexibility Analysis.

The Analysis notes that the amendments implement a haircut methodology which employs a mathematical formula to determine the theoretical value of options. The purpose of the amendments is to make haircuts more accurately reflect the risks associated with dealer option positions than is possible under the current rule and to simplify the net capital rule's treatment of options for capital purposes. The amendments permit the use of a model (other than a proprietary model) maintained and operated by a third-party source, including OCC, and approved according to the terms of the amendments. The amendments will impact approximately 247 ''small entities'' which are subject to the provisions of Rule 15c3–1 and have listed options positions insofar as they would be required to implement a computer interface with a third-party vendor in order to receive reliable data to calculate haircuts. The Commission recognizes, however, that some broker-dealers with very limited options positions might find it cost prohibitive to install such computerized interface with a model provider. In order to reduce the economic impact on these broker-dealers, the amendments include an alternative haircut methodology that is based on the basic options strategies used by broker-dealers, and is similar to the approach used in the current rule.

The Analysis also states that no federal securities laws duplicate, overlap, or conflict with the amendments, and adds that the Commission does not believe any less burdensome alternatives are available to accomplish the objectives of the amendments. In addition, the Analysis notes that the staff carefully considered the possibility that smaller broker-dealers who elect the strategy-based approach may receive more severe haircut treatment than under the current rule because the strategy-based approach under the amendments is limited to a few very simple strategies. Because the Commission intended to eliminate the complicated overlay of strategies and interpretations that developed under the former rule to accommodate all dealer options strategies, and because smaller broker-dealers which elect the alternate approach will not be required to incur the costs associated with adopting a new system to employ models, the Commission believes the amendments should have a minimal adverse impact on small businesses or small organizations. As such, the amendments contain no additional reporting, recordkeeping, or other compliance requirements. For additional information, a copy of the Analysis may be obtained by contacting Peter Geraghty (202/942–0177) or Louis A. Randazzo (202/942–0191), Division of Market Regulation, Securities and Exchange Commission, Washington, D.C. 20549.

V. Paperwork Reduction Act

The text of the amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[21] Broker-dealers subject to the rule are required to notify the Commission and the appropriate designated examining authority whenever their level of net capital falls below a prescribed level for any period exceeding three business days, and whenever there is a liquidating deficit in a specialist's market-maker account. These same notification obligations exist under the present rule before adoption of the amendments.[22] Consequently, the amendment does not change the PRA collection of information requirements or burden under Rule 15c3–1. The Commission recently received an extension from the Office of Management and Budget (''OMB'') for the collection of information requirements contained in Rule 15c3–1. The title of the collection of information is ''Net Capital Requirements for Brokers and Dealers, Rule 15c3–1.'' The OMB control number is 3235–0200. The Commission also reminds brokers and dealers subject to the amendments about their related recordkeeping obligations under Rule 17a–4.

VI. Statutory Analysis

Pursuant to the Securities Exchange Act of 1934 and particularly Section 15(c)(3), (15 U.S.C. 78o(c)(3)) thereof, the Commission is adopting amendments to § 240.15c3–1 of Title 17 of the Code of Federal Regulations in the manner set forth below.

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of Final Rule

In accordance with the foregoing, Title 17, chapter II, part 240 of the Code of Federal Regulations is amended as follows:

Part 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.15c3–1 is amended by removing and reserving paragraph (a)(7).

3. Section 240.15c3–1 is amended by adding an undesignated center heading before paragraph (c)(2)(x) and revising paragraph (c)(2)(x) to read as follows:

§ 240.15c3–1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

Brokers or Dealers Carrying Accounts of Listed Options Specialists

(x)(A) With respect to any transaction of a specialist in listed options, who is either not otherwise subject to the provisions of this section or is described in paragraph (c)(2)(vi)(N) of this section, for whose specialist account a broker or dealer acts as a guarantor, endorser, or carrying broker or dealer, such broker or dealer shall adjust its net worth by deducting as of noon of each business day the amounts computed as of the prior business day pursuant to § 240.15c3–1a. The required deductions may be reduced by any liquidating equity that exists in such specialist's market-maker account as of that time and shall be increased to the extent of any liquidating deficit in such account. Noon shall be determined according to

statute permits agencies to formulate their own definitions. The Commission has adopted definitions of the term ''small entity'' for purposes of Commission rulemaking in accordance with the Regulatory Flexibility Act. Those definitions are set forth in Rule 0–10, 17 CFR 240.0–10. *See* Securities Exchange Act Release No. 18452 (January 28, 1982), 47 FR 5215 (February 4, 1982). A broker-dealer is a ''small business'' or ''small organization'' under Rule 0–10, if the broker-dealer (i) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to 17 CFR 240.17–5(d) or, if not required to file such statements, a broker-dealer that had total net capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in 17 CFR 240.0–10.

[21] 44 U.S.C. § 3501 *et seq.*

[22] *See* Rule 15c3–1(c)(2)(x).

the local time where the broker or dealer is headquartered. In no event shall excess equity in the specialist's market-maker account result in an increase of the net capital of any such guarantor, endorser, or carrying broker or dealer.

(B) *Definitions.* (*1*) The term *listed option* shall mean any option traded on a registered national securities exchange or automated facility of a registered national securities association.

(*2*) For purposes of this section, the equity in an individual specialist's market-maker account shall be computed by:

(*i*) Marking all securities positions long or short in the account to their respective current market values;

(*ii*) Adding (deducting in the case of a debit balance) the credit balance carried in such specialist's market-maker account; and

(*iii*) Adding (deducting in the case of short positions) the market value of positions long in such account.

(C) No guarantor, endorser, or carrying broker or dealer shall permit the sum of the deductions required pursuant to § 240.15c3–1a in respect of all transactions in specialists' market-maker accounts guaranteed, endorsed, or carried by such broker or dealer to exceed 1,000 percent of such broker's or dealer's net capital as defined in § 240.15c3–1(c)(2) for any period exceeding three business days. If at any time such sum exceeds 1,000 percent of such broker's or dealer's net capital, then the broker or dealer shall:

(*1*) Immediately transmit telegraphic or facsimile notice of such event to the Division of Market Regulation in the headquarters office of the Commission in Washington, D.C., to the district or regional office of the Commission for the district or region in which the broker or dealer maintains its principal place of business, and to its examining authority designated pursuant to section 17(d) of the Act (15 U.S.C. 78q(d)) (''Designated Examining Authority''); and

(*2*) Be subject to the prohibitions against withdrawal of equity capital set forth in § 240.15c3–1(e) and to the prohibitions against reduction, prepayment, and repayment of subordination agreements set forth in paragraph (b)(11) of § 240.15c3–1d, as if such broker or dealer's net capital were below the minimum standards specified by each of those paragraphs.

(D) If at any time there is a liquidating deficit in a specialist's market-maker account, then the broker or dealer guaranteeing, endorsing, or carrying listed options transactions in such specialist's market-maker account may not extend any further credit in that account, and shall take steps to liquidate promptly existing positions in the account. This paragraph shall not prevent the broker or dealer from, upon approval by the broker's or dealer's Designated Examining Authority, entering into hedging positions in the specialist's market-maker account. The broker or dealer also shall transmit telegraphic or facsimile notice of the deficit and its amount by the close of business of the following business day to its Designated Examining Authority and the Designated Examining Authority of the specialist, if different from its own.

(E) Upon written application to the Commission by the specialist and the broker or dealer guaranteeing, endorsing, or carrying options transactions in such specialist's market-maker account, the Commission may approve upon specified terms and conditions lesser adjustments to net worth than those specified in § 240.15c3–1a.

* * * * *

4. Section 240.15c3–1a is revised to read as follows:

§ 240.15c3–1a Options (Appendix A to 17 CFR 240.15c3–1).

(a) *Definitions.* (1) The term *unlisted option* shall mean any option not included in the definition of listed option provided in paragraph (c)(2)(x) of § 240.15c3–1.

(2) The term *option series* refers to listed option contracts of the same type (either a call or a put) and exercise style, covering the same underlying security with the same exercise price, expiration date, and number of underlying units.

(3) The term *related instrument* within an option class or product group refers to futures contracts and options on futures contracts covering the same underlying instrument. In relation to options on foreign currencies a related instrument within an option class also shall include forward contracts on the same underlying currency.

(4) The term *underlying instrument* refers to long and short positions, as appropriate, covering the same foreign currency, the same security, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days. If the exchange or conversion requires the payment of money or results in a loss upon conversion at the time when the security is deemed an underlying instrument for purposes of this Appendix A, the broker or dealer will deduct from net worth the full amount of the conversion loss. The term underlying instrument shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments.

(5) The term *options class* refers to all options contracts covering the same underlying instrument.

(6) The term *product group* refers to two or more option classes, related instruments, underlying instruments, and qualified stock baskets in the same portfolio type (see paragraph (b)(1)(ii) of this section) for which it has been determined that a percentage of offsetting profits may be applied to losses at the same valuation point.

(b) The deduction under this Appendix A to § 240.15c3–1 shall equal the sum of the deductions specified in paragraphs (b)(1)(v)(C) or (b)(2) of this section.

Theoretical Pricing Charges

(1)(i) *Definitions.*

(A) The terms *theoretical gains and losses* shall mean the gain and loss in the value of individual option series, the value of underlying instruments, related instruments, and qualified stock baskets within that option's class, at 10 equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument equal to the percentage corresponding to the deductions otherwise required under § 240.15c3–1 for the underlying instrument (See paragraph (a)(1)(iii) of this section). Theoretical gains and losses shall be calculated using a theoretical options pricing model that satisfies the criteria set forth in paragraph (a)(1)(i)(B) of this section.

(B) The term *theoretical options pricing model* shall mean any mathematical model, other than a broker-dealer proprietary model, approved by a Designated Examining Authority. Such Designated Examining Authority shall submit the model to the Commission, together with a description of its methods for approving models. Any such model shall calculate theoretical gains and losses as described in paragraph (a)(1)(i)(A) of this section for all series and issues of equity, index and foreign currency options and related instruments, and shall be made available equally and on the same terms to all registered brokers or dealers. Its procedures shall include the arrangement of the vendor to supply accurate and timely data to each broker-dealer with respect to its services, and the fees for distribution of the services. The data provided to brokers or dealers shall also contain the minimum requirements set forth in paragraphs (b)(1)(v)(C) of this section and the

product group offsets set forth in paragraphs (b)(1)(v)(B) of this section. At a minimum, the model shall consider the following factors in pricing the option:

(*1*) The current spot price of the underlying asset;
(*2*) The exercise price of the option;
(*3*) The remaining time until the option's expiration;
(*4*) The volatility of the underlying asset;
(*5*) Any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and
(*6*) The current term structure of interest rates.

(C) The term *major market foreign currency* shall mean the currency of a sovereign nation whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market. For purposes of this section, the European Currency Unit (ECU) shall be deemed a major market foreign currency.

(D) The term *qualified stock basket* shall mean a set or basket of stock positions which represents no less than 50% of the capitalization for a high-capitalization or non-high-capitalization diversified market index, or, in the case of a narrow-based index, no less than 95% of the capitalization for such narrow-based index.

(ii) With respect to positions involving listed options in a single specialist's market-maker account, and, separately, with respect to positions involving listed option positions in its proprietary or other account, the broker or dealer shall group long and short positions into the following portfolio types:

(A) Equity options on the same underlying instrument and positions in that underlying instrument;

(B) Options on the same major market foreign currency, positions in that major market foreign currency, and related instruments within those options' classes;

(C) High-capitalization diversified market index options, related instruments within the option's class, and qualified stock baskets in the same index;

(D) Non-high-capitalization diversified index options, related instruments within the index option's class, and qualified stock baskets in the same index; and

(E) Narrow-based index options, related instruments within the index option's class, and qualified stock baskets in the same index.

(iii) Before making the computation, each broker or dealer shall obtain the theoretical gains and losses for each options series and for the related and underlying instruments within those options' class in each specialist's market-maker account guaranteed, endorsed, or carried by a broker or dealer, or in the proprietary or other accounts of that broker or dealer. For each option series, the theoretical options pricing model shall calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or a decrease of the following percentages of the daily market price of the underlying instrument:

(*A*) +(−)15% for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes;
(*B*) +(−)6% for major market foreign currencies;
(*C*) +(−) 20% for all other currencies; and
(*D*) +(−)10% for high-capitalization diversified indexes.

(iv)(A) As to non-clearing option specialists and market-makers, the percentages of the daily market price of the underlying instrument shall be:

(*1*) +(−) 4½% for major market foreign currencies; and
(*2*) +6(−)8% for high-capitalization diversified indexes.
(*3*) +(−) 10% for a non-clearing market-maker, or specialist in non-high capitalization diversified index product group.

(B) The provisions of this paragraph (b)(1)(iv) shall expire two years from September 1, 1997, unless otherwise extended by the Commission.

(v)(A) The broker or dealer shall multiply the corresponding theoretical gains and losses at each of the 10 equidistant valuation points by the number of positions held in a particular options series, the related instruments and qualified stock baskets within the option's class, and the positions in the same underlying instrument.

(B) In determining the aggregate profit or loss for each portfolio type, the broker or dealer will be allowed the following offsets in the following order, provided, that in the case of qualified stock baskets, the broker or dealer may elect to net individual stocks between qualified stock baskets and take the appropriate deduction on the remaining, if any, securities:

(*1*) First, a broker or dealer is allowed the following offsets within an option's class:

(*i*) Between options on the same underlying instrument, positions covering the same underlying instrument, and related instruments within the option's class, 100% of a position's gain shall offset another position's loss at the same valuation point;

(*ii*) Between index options, related instruments within the option's class, and qualified stock baskets on the same index, 95%, or such other amount as designated by the Commission, of gains shall offset losses at the same valuation point;

(*2*) Second, a broker-dealer is allowed the following offsets within an index product group:

(*i*) Among positions involving different high-capitalization diversified index option classes within the same product group, 90% of the gain in a high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in a different high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class;

(*ii*) Among positions involving different non-high-capitalization diversified index option classes within the same product group, 75% of the gain in a non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iii*) Among positions involving different narrow-based index option classes within the same product group, 90% of the gain in a narrow-based market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another narrow-based market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iv*) No qualified stock basket should offset another qualified stock basket; and

(*3*) Third, a broker-dealer is allowed the following offsets between product groups: Among positions involving different diversified index product groups within the same market group, 50% of the gain in a diversified market index option, a related instrument, or a qualified stock basket within that index option's product group shall offset the

loss at the same valuation point in another product group;

(C) For each portfolio type, the total deduction shall be the larger of:

(*1*) The amount for any of the 10 equidistant valuation points representing the largest theoretical loss after applying the offsets provided in paragraph (b)(1)(v)(B) if this section; or

(*2*) A minimum charge equal to 25% times the multiplier for each equity and index option contract and each related instrument within the option's class or product group, or $25 for each option on a major market foreign currency with the minimum charge for futures contracts and options on futures contracts adjusted for contract size differentials, not to exceed market value in the case of long positions in options and options on futures contracts; plus

(*3*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 5% of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes; and

(*4*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 7½% of the market value of the qualified stock basket for non-high-capitalization diversified indexes.

Alternative Strategy Based Method

(2) A broker or dealer may elect to apply the alternative strategy based method in accordance with the provisions of this paragraph (b)(2).

(i) *Definitions.* (A) The term *intrinsic value* or *in-the-money amount* shall mean the amount by which the exercise value, in the case of a call, is less than the current market value of the underlying instrument, and, in the case of a put, is greater than the current market value of the underlying instrument.

(B) The term *out-of-the-money amount* shall mean the amount by which the exercise value, in the case of a call, is greater than the current market value of the underlying instrument, and, in the case of a put, is less than the current market value of the underlying instrument.

(C) The term *time value* shall mean the current market value of an option contract that is in excess of its intrinsic value.

(ii) Every broker or dealer electing to calculate adjustments to net worth in accordance with the provisions of this paragraph (b)(2) must make the following adjustments to net worth:

(A) Add the time value of a short position in a listed option; and

(B) Deduct the time value of a long position in a listed option, which relates to a position in the same underlying instrument or in a related instrument within the option class or product group as recognized in the strategies enumerated in paragraph (b)(2)(iii)(D) of this section; and

(C) Add the net short market value or deduct the long market value of listed options as recognized in the strategies enumerated in paragraphs (b)(2)(iii)(E)(*1*) and (*2*) of this section.

(iii) In computing net capital after the adjustments provided for in paragraph (b)(2)(ii) of this section, every broker or dealer shall deduct the percentages specified in this paragraph (b)(2)(iii) for all listed option positions, positions covering the same underlying instrument and related instruments within the options' class or product group.

Uncovered Calls

(A) Where a broker or dealer is short a call, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for such option reduced by its out-of-the-money amount, to the extent that such reduction does not operate to increase net capital. In no event shall this deduction be less than the greater of $250 for each short call option contract for 100 shares or 50% of the aforementioned percentage.

Uncovered Puts

(B) Where a broker or dealer is short a put, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for such option reduced by its out-of-the-money amount, to the extent that such reduction does not operate to increase net capital. In no event shall the deduction provided by this paragraph be less than the greater of $250 for each short put option contract for 100 shares or 50% of the aforementioned percentage.

Long Positions

(C) Where a broker or dealer is long puts or calls, deducting 50 percent of the market value of the net long put and call positions in the same options series.

Certain Security Positions With Offsetting Options

(D)(*1*) Where a broker or dealer is long a put for which it has an offsetting long position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the long offsetting position, not to exceed the out-of-the-money amount of the option. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares, provided that the minimum charge need not exceed the intrinsic value of the option.

(*2*) Where a broker or dealer is long a call for which it has an offsetting short position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the short offsetting position, not to exceed the out-of-the-money amount of the option. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares, provided that the minimum charge need not exceed the intrinsic value of the option.

(*3*) Where a broker or dealer is short a call for which it has an offsetting long position in the same number of units of the same underlying instrument, deducting the percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1 of the current market value of the underlying instrument for the offsetting long position reduced by the short call's intrinsic value. In no event shall the deduction provided by this paragraph be less than $25 for each option contract for 100 shares.

Certain Spread Positions

(E)(*1*) Where a broker or dealer is short a listed call and is also long a listed call in the same class of options contracts and the long option expires on the same date as or subsequent to the short option, the deduction, after adjustments required in paragraph (b) of this section, shall be the amount by which the exercise value of the long call exceeds the exercise value of the short call. If the exercise value of the long call is less than or equal to the exercise value of the short call, no deduction is required.

(*2*) Where a broker or dealer is short a listed put and is also long a listed put in the same class of options contracts and the long option expires on the same date as or subsequent to the short option, the deduction, after the adjustments required in paragraph (b) of this section, shall be the amount by which the exercise value of the short put exceeds the exercise value of the long put. If the exercise value of the long put is equal to or greater than the

exercise value of the short put, no deduction is required.

(c) With respect to transactions involving unlisted options, every broker or dealer shall determine the value of unlisted option positions in accordance with the provision of paragraph (c)(2)(i) of § 240.15c3–1, and shall deduct the percentages of all securities positions or unlisted options in the proprietary or other accounts of the broker or dealer specified in this paragraph (c). However, where computing the deduction required for a security position as if the security position had no related unlisted option position and positions in unlisted options as if uncovered would result in a lesser deduction from net worth, the broker or dealer may compute such deductions separately.

Uncovered Calls

(1) Where a broker or dealer is short a call, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the security underlying such option reduced by any excess of the exercise value of the call over the current market value of the underlying security. In no event shall the deduction provided by this paragraph be less than $250 for each option contract for 100 shares.

Uncovered Puts

(2) Where a broker or dealer is short a put, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the security underlying the option reduced by any excess of the market value of the underlying security over the exercise value of the put. In no event shall the deduction provided by this paragraph be less than $250 for each option contract for 100 shares.

Covered Calls

(3) Where a broker or dealer is short a call and long equivalent units of the underlying security, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the underlying security reduced by any excess of the current market value of the underlying security over the exercise value of the call. No reduction under this paragraph shall have the effect of increasing net capital.

Covered Puts

(4) Where a broker or dealer is short a put and short equivalent units of the underlying security, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the underlying security reduced by any excess of the exercise value of the put over the market value of the underlying security. No such reduction shall have the effect of increasing net capital.

Conversion Accounts

(5) Where a broker or dealer is long equivalent units of the underlying security, long a put written or endorsed by a broker or dealer and short a call in its proprietary or other accounts, deducting 5 percent (or 50 percent of such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the current market value of the underlying security.

(6) Where a broker or dealer is short equivalent units of the underlying security, long a call written or endorsed by a broker or dealer and short a put in his proprietary or other accounts, deducting 5 percent (or 50 percent of such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the market value of the underlying security.

Long Options

(7) Where a broker or dealer is long a put or call endorsed or written by a broker or dealer, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi) (A) through (K) of § 240.15c3–1) of the market value of the underlying security, not to exceed any value attributed to such option in paragraph (c)(2)(i) of § 240.15c3–1.

By the Commission.

Dated: February 6, 1997.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–3479 Filed 2–11–97; 8:45 am]

BILLING CODE 8010–01–P

DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 117

[CGDO1–95–171]

RIN 2115–AE47

Drawbridge Operation Regulations; Passaic River, New Jersey

AGENCY: Coast Guard, DOT.

ACTION: Final rule.

SUMMARY: The Coast Guard is changing the regulations governing the Routes 1 & 9 (Lincoln Highway) Bridge, mile 1.8, the Point-No-Point Railroad Bridge, mile 2.6, both in Newark, New Jersey, and the Route 7 (Rutgers Street) Bridge, mile 8.9, in Belleville, New Jersey which cross the Passaic River. The change will provide openings on signal if at least four hours notice is given. This change was requested by the Consolidated Rail Corporation (CONRAIL) and New Jersey Department of Transportation (NJDOT) because of the limited openings of these bridges. This action will relieve the bridge owners of the burden of having personnel constantly available to open the bridges and should provide for the reasonable needs of navigation. Other changes remove redundant requirements that are included in the Part 117 general operating regulations, provide maximum allowable time delays for specific railroad bridge openings, remove unnecessary language, and reorder the paragraphs for clarity and consistency.

EFFECTIVE DATE: March 14, 1997.

ADDRESSES: Documents referred to in this preamble are available by writing to the First Coast Guard District, Bridge Branch at Bldg. 135A, Governors Island, New York 10004–5073. The telephone number is (212) 668–7994.

FOR FURTHER INFORMATION CONTACT: Gary Kassof, Chief, Bridge Branch, (212) 668–7021.

SUPPLEMENTARY INFORMATION:

Regulatory History

On June 21, 1996, the Coast Guard published a notice of proposed rulemaking entitled ''Drawbridge Operation Regulations; Passaic River, New Jersey'' in the Federal Register (61 FR 31881). The Coast Guard received three comments on the notice of proposed rulemaking. No public hearing was requested, and none was held.

Background and Purpose

The Routes 1 & 9 (Lincoln Highway), Point-No-Point Railroad, and Route 7 (Rutgers Street) Bridges have respective vertical clearances, when in the closed position, of 40′, 16′, and 8′ above mean high water (MHW). All three bridges had previously been required to open on signal. This rule will permit these bridges to open on signal if at least four hours notice is given.

Due to the closure of the River Oil Terminal in August, 1992, requests for openings of bridges across the Passaic River have decreased. For the years 1992, 1993, and 1994, the Routes 1 & 9 (Lincoln Highway) Bridge opened 95, 35 and 29 times, respectively, for vessel transits; the Point-No-Point Bridge opened 243, 145 and 124 times; the Route 7 (Rutgers Street) Bridge opened 129, 161 and 169 times. The previous regulations are being changed to provide