



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 8, 1998

Mr. Howard Spindel
Managing Director
Integrated Management Solutions
32 Broadway, Suite 1200
New York, New York 10004-1609

Re: Capital Treatment of Options Hedged with Convertible Securities

Dear Mr. Spindel:

This is in response to your letter dated October 21, 1997, regarding the treatment of option positions offset by convertible securities for net capital purposes under Rule 15c3-1 of the Securities Exchange Act of 1934 (17 CFR 240.15c3-1) and Appendix A to that rule (17 CFR 240.15c3-1a).

Based on your letter and subsequent discussions with the staff of the Division of Market Regulation ("Division"), I understand the following facts to be pertinent to your request. A broker-dealer purchases a convertible bond at a price where, if converted, the resulting position would be the equivalent of purchasing the underlying security at a price substantially above its current market value (the "effective price").¹ Simultaneously, the broker-dealer sells a deep out-of-the-money call option. You believe that the downside risk associated with bond ownership is adequately accounted for by its normal haircut. You also believe that by selling the call option, the broker-dealer has mitigated some downside exposure if the price of the bond declines, but forfeits the gains (assuming assignment of the call option) if the price of the underlying security rises beyond its exercise price. Consequently, you assert that these positions hedge one another at some point and therefore the haircut on the call option should be zero where the effective price

¹ For example, if a convertible bond has a current market value of \$1,100 and is convertible into 100 shares of the underlying security, currently selling at \$5 per share, the effective conversion price of the underlying security would be equal to \$11 per share, or \$6 more than its current market value.

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at which the underlying security would be acquired upon conversion of the bond is less than the exercise price of the call option which it covers.

Appendix A sets forth the capital treatment for broker-dealers' proprietary positions in both listed and unlisted options. Appendix A permits certain offsets between an option position and a security underlying the option (*i.e.*, "underlying instrument"). Paragraph (a)(4) of Appendix A defines the term underlying instrument to include, among other things, long and short positions, as appropriate, covering the same security or a security which is convertible into the underlying security within 90 days. Paragraph (a)(4) further states that the full amount of any loss upon conversion occurring at the time when a security is deemed an underlying instrument must be deducted from a broker-dealer's net worth. In other words, total conversion loss is the amount by which the effective price of the underlying security (assuming bond conversion) exceeds the current market price of the underlying instrument.

If a broker-dealer elects to treat a collective option and bond position as offsetting, you believe that Paragraph (a)(4) would require the broker-dealer to deduct the sum of the total conversion loss and the covered call deduction required by paragraph (c)(3),² less any premium received from selling the call. You believe that this charge is excessive.

You further believe that treating the option and bond positions separately (*i.e.*, uncovered), also yields an excessive haircut. You state that this treatment would require a 15% charge on the bond's current market value (assuming it is non-investment grade) and, for the option position, a 15% charge on the current market value of the securities underlying the option (assuming an equity security underlies the option) less the option's out-of-the-money amount, subject to minimum charges prescribed by Rule 15c3-1a(b)(2)(iii)(A) and (c)(1) of not less than \$250 per option contract or, if greater, as to listed options, 50% of the haircut required above (*i.e.*, 7.5%).

Based upon the facts set forth above, the Division will not recommend enforcement action to the Securities and Exchange Commission ("Commission") as to the alternative strategy based method if a broker-dealer elects to treat separately for haircut purposes (*i.e.*, uncovered) those short out-of-the-money call options which offset long convertible securities convertible into the same number of units in the same underlying instrument, but applies only a \$25 per 100 share minimum charge to the short call options instead of the minimum charges prescribed by Rule 15c3-1a(b)(2)(iii)(A) and (c)(1). This would be permitted for both listed and unlisted options. As soon as the call option position is at- or in-the-money, this treatment is not permitted.

² A 15% deduction is applied to the converted securities position.

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Any firm electing to apply this treatment must be able to demonstrate to its designated examining authority that the call options offset by convertible securities represent a bona fide hedge, and is not otherwise designed to circumvent the net capital rule.

You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely yours,



Michael A. Macchiaroli
Associate Director

MAM/mma

cc: Mr. Thomas Cassella
NASD Regulation, Inc.

Mr. Raymond J. Hennessy
New York Stock Exchange, Inc.

Ms. Diane Anderson
Philadelphia Stock Exchange

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