

M E M O R A N D U M

August 10, 1982

TO: Ed Greene, General Counsel

FROM: Rick Ketchum, Associate Director *RK*
Division of Market Regulation

RE: Proposed Rule 3a12-7

As you know, the Division is recommending that the Commission issue a release proposing Rule 3a12-7 under the Act which would designate as exempted securities options on government securities if such options are traded exclusively over-the-counter ("OTC"). This memorandum is in response to your request for a brief discussion of the rationale for not extending this designation to standardized options which may in the future be traded on a national securities exchange.

OTC options on government securities have developed as a hedging adjunct to the government securities market. The participants in this market are almost entirely professionals who have substantial capital and trading expertise. Because of the size of transactions in this market (typically \$1 million or more) and the fact that indications of interest are not publicly disseminated, public investors generally have not participated in that market. In the past, the Commission has not required securities firms that conduct a business exclusively in government securities and OTC government options to register as broker-dealers. However, as you know, the proposed legislation resulting from the SEC/CFTC Accord would specifically define an option on a government security as a separate security. Therefore, without the adoption of proposed Rule 3a12-7, a number of firms would be required to either register as broker-dealers or substantially revise their present business.

In contrast, the proposed exchange standardized options markets in government securities are expected to attract substantial numbers of public investors. ^{1/} As a result, each of the options SRO's have implemented rules which provide for similar "selling practice" rules (such as suitability and supervisory requirements) to those presently in place for equity options. These exchange rules are, of course, in addition to Commission's regulatory framework for all non-exempt securities intended to ensure public investor protection and the financial responsibility of public brokerage firms.

^{1/} In this regard, in the months following Commission approval of a GNMA options exam, over 10,000 of the estimated 45,000 registered representatives currently engage in a public options business took the GNMA options exam.

However, if standardized government options were designated as exempt securities, exempt government securities firms (which include subsidiaries of major retail brokerage firms such as Merrill Lynch) could sell these options to public customers without being subject to any of the options SROs' "selling practice" rules. Moreover, those firms would not be subject to net capital requirements nor would their customers be subject to either specific initial or maintenance margin requirements. The Division believes that such a gap in a public market, which investors will perceive to be closely regulated by the Commission, is unacceptable. 2/

Because of the substantial effects the SEC/CFTC legislation would have on their present business, government securities firms are eager to see proposed Rule 3a12-7 adopted as soon as possible. Therefore, if you agree, we would plan on calendaring the rule proposal at the earliest possible date so as to ensure that those firms do not further complicate the enactment of the Accord.

2/ This, of course, does not mean that exempt government securities firms cannot use the exchange government options markets. Those firms would be permitted to trade for their proprietary accounts without endangering their exception.