

WEDBUSH, NOBLE, COOKE, INC.

MEMBER
AMERICAN
C.B.O.E.
NEW YORK
PACIFIC & OTHER
EXCHANGE

616 SOUTH SPRING STREET
LOS ANGELES, CALIFORNIA 90014
(213) 620-1750

August 10, 1976

The Honorable Roderick M. Hills
Chairman
Securities and Exchange Commission
500 North Capitol Street, N. W.
Washington, D. C. 20549

Dear Chairman Hills:

On behalf of my firm and the Pacific Stock Exchange, of which I am Chairman of the Board, I have been discussing for some months with members of the Commission Staff a matter which I believe to be of great importance to the Pacific Stock Exchange and to the capital structure underlying the nation's options markets. While the Commission Staff has been invariably courteous and has listened to our presentations with commendable attention and understanding, we have the feeling that the Staff is having great difficulty formulating policy in this area because of uncertainty about the Commission's attitude toward questions relating to options trading. We are writing you in the hope that understanding by the Commission of the questions we have raised may facilitate Staff consideration of this matter.

The problem with which we are concerned is that the Uniform Net Capital Rule (Rule 15c3-1) has led to an extreme concentration in the clearing and financing of options market making activities. On the Pacific Stock Exchange two firms clear over 90% of all options market makers. We believe that no more than four or five firms account for the vast majority of clearing activity for all options market making in the country. This extreme concentration is undesirable for many reasons, but it poses particular problems for the Pacific Stock Exchange which is finding that the growth of its infant options market is being stunted by a shortage of capital committed to market making on its floor.

The Honorable Roderick M. Hills

August 10, 1976

Page 2

This concentration exists, in substantial part, because Rule 15c3-1 imposes prohibitive capital charges (pursuant to Appendix A) on firms that engage in options market making through their own employees, while firms that clear for "independent" market makers face much less substantial capital charges (pursuant to 15c3-1(c) (2) (x) or 15c3-1 (c) (2) (xi)).

The extreme difference in capital charges is illustrated on the enclosed chart which shows the capital charges applicable to Wedbush, Noble, Cooke, Inc. on July 8, 1976 as a result of the actual options positions maintained by two options market makers, on the alternative assumptions that these individuals were employees or independents. In fact, the Pacific Stock Exchange market maker shown on the chart is an independent, clearing through my firm, while my firm's American Stock Exchange specialist unit is composed of employees. The day chosen was not unusual; we believe that any other day would show similar results. The actual positions maintained, and the back-up calculations, have been furnished to Daniel Piliero of the Commission Staff.

The enormous disparities in capital charges that are shown by this chart do not bear any relationship to risks involved. These disparities do, however, effectively prohibit firms like my own, and like Mitchum, Jones & Templeton, Inc., which have traditionally been major sources of capital for the Pacific Stock Exchange's markets, from participating in options market making to a significant degree.

Admittedly we can, as illustrated by the chart, escape the enormous capital charges of Appendix A by clearing for independent market makers. Our experience, however, over many years is with backing employee market makers. We have much greater confidence in our ability to manage and control our risks with employee market makers than with independents, so that we are much more willing to commit our capital to market making through employees than through independents. We are frustrated from proceeding as we would normally proceed, as businessmen, because the Uniform Net Capital Rule imposes a very high charge for activity which we believe is relatively less risky and a much lower charge for activity which, in our business judgment, is relatively more risky.

Given a solution to the disparity in capital charges illustrated by the chart, I believe that my firm, as well as others, could play a substantial role in options market making on the Pacific Stock Exchange, and I believe that the options markets on that Exchange could be substantially improved by the capital and competition that would thus be introduced.

The solution that we have proposed to the Staff is the creation of a non-guaranteed corporate subsidiary which would engage in options market making through its own employees. The positions of these market makers would be cleared through Wedbush, Noble, Cooke, the parent, as a clearing member of Options Clearing Corporation, pursuant to Letters of Guarantee, issued with respect to the market makers in the usual form required by the options exchanges and Options Clearing Corporation. The

The Honorable Roderick M. Hills

August 10, 1976

Page 3

subsidiary, which would be subject to Rule 15c3-1, would have its market maker positions cleared by the parent in accordance with Rule 15c3-1 (a) (6) (iv), and the parent would compute the capital effect of carrying the market maker and specialist positions of the subsidiary in accordance with Rule 15c3-1 (c) (2) (xi). Through our counsel we have requested from the Staff either a no action position or an interpretation, with respect to our proposed method of operating.

This letter is only a summary of points we have made in oral and written submissions to the Staff. As we noted above, we have found the Staff members with whom we have discussed this question, including Lee Pickard, Daniel Piliero, and Nelson Kibler, to be highly knowledgeable in this area, and we are sure they can supply you with additional information you may desire. We have contacted you at this time because of the urgency we attach to obtaining a solution that will allow firms like ours to commit greater capital to the Pacific Stock Exchange's options market place, which, in light of the significant losses incurred to date by the Exchange in this area, needs to grow if it is to remain viable.

Sincerely,

WEDBUSH, NOBLE, COOKE, INC.

Edward W. Wedbush
President

EWV/ac

Enclosure

cc: Philip A. Loomis, Jr., Commissioner
John R. Evans, Commissioner
Irving M. Pollack, Commissioner
Lee A. Pickard, Director
Daniel J. Piliero II, Associate Director
Nelson Kibler, Assistant Director

EMPLOYEE vs. INDEPENDENT MARKET MAKER

OPTIONS CAPITAL CHARGE

SUMMARY JULY 8, 1976

		CAPITAL CHARGE	
		EMPLOYEE	INDEPENDENT
<p>W. SPENCER P.S.E. MARKET MAKER</p>			
<p style="text-align: center;"><u>OPTION POSITION</u></p>			
<p><u>LONG</u> \$89,300</p>	<p><u>SHORT</u> \$36,400</p>	\$402,700	\$30,600
<p>WEDBUSH, NOBLE, COOKE, INC. A.S.E. SPECIALIST UNIT</p>			
<p style="text-align: center;"><u>OPTION POSITION</u></p>			
<p><u>LONG</u> \$76,700</p>	<p><u>SHORT</u> \$48,700</p>	\$123,700	\$23,000