

DATE: July 10, 2002

TO: Options Clearing Member Organizations

FROM: Division of Regulatory Services

SUBJECT: Terminated Option Market-Maker Broker-Dealers

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KEY ISSUES

- Accounts of former options market-makers that: (a) have terminated all exchange memberships; (b) have had their broker-dealer registration terminated by the SEC; and (c) are carried on the books and records of a clearing firm must be treated as customers pursuant to the Customer Protection Rule, unless the former market-maker subordinates all claims to his account to other creditors of the clearing firm.
- Existing positions previously initiated as an options market-maker will continue to receive good faith margin. In the case of options, good faith margin will extend to each position through expiration of the particular options contracts.
- Activity and positions entered into as a non-market-maker customer in an account that is subject to a subordination agreement are still subject to customer margin requirements.
- The Customer Protection Rule, SEC Rule 15c3-3, was established to ensure that in the event of broker-dealer failure, sufficient capital would be available to safeguard customers' funds and securities and to protect the rights of customers to obtain their property from the broker-dealer.
- Broker-dealers and customers who are subordinated lenders to the extent of the assets subordinated are specifically excluded from the definition of customer in the Customer Protection Rule.

DISCUSSION

When an options market-maker terminates his exchange membership(s) and is unassigned to a designated examining authority, the market-maker is assigned to the SEC. After a period of time, the SEC will terminate the market-maker's broker-dealer

registration. Accounts of former options market-makers that: (a) have terminated all exchange memberships; (b) have had their broker-dealer registration terminated by the SEC before all existing positions are liquidated; and (c) are carried on the books and records of a clearing firm must be treated as customers pursuant to the Customer Protection Rule.

Situations may arise where an options market-maker terminates his exchange membership(s) prior to closing all existing positions. Many market-maker clearing firms have a policy to allow a reasonable time to liquidate the existing positions in order to prevent a rapid liquidation that may result in significant losses to the former broker-dealer and possibly the clearing firm.

Clearing firms should note that being subject to the Customer Protection Rule requires the clearing firm to prepare customer reserve formula computations to determine the amount required to be deposited into a special reserve bank account for the exclusive benefit of customers. In addition, clearing firms must determine the quantity of fully paid and excess margin securities required being in possession and control.

Finally, the carrying of any non-broker-dealer customer accounts requires a clearing firm to prepare the PAIB computation weekly since it no longer qualifies for the exemption¹ provided in the SEC's no-action letter.

Any opening transactions initiated in the account of a former market-maker must be cleared in the customer range and margined as customer. It should be noted that the existing positions that were put on as a market-maker will continue to receive good faith margin. In the case of options, good faith margin will extend to each position through expiration of the particular options contract.

As an alternative to treating the former options market-maker as a customer, a market-maker may enter into a written agreement with the clearing firm to subordinate certain assets whereby those assets are not afforded protection under the customer protection rule. These assets are specifically excluded from the definition of customer in the Customer Protection Rule. The clearing firm's designated examining authority must approve the subordination agreements.

Questions regarding this circular may be directed to Robert Gardner (312) 786-7937 or Peter Dorenbos (312) 786-7414, in the Exchange's Department of Financial and Sales Practice Compliance.

¹ Any clearing broker that does not carry "customers" as defined by Rule 15c3-3 and does not have a PAIB ("Proprietary Account of Introducing Brokers and Dealers") deposit requirement may make its PAIB reserve computation monthly rather than weekly. PAIB credits represent clearing firm payables to the introducing brokers; PAIB debits represent clearing firm receivables from the introducing brokers. Excess credits over debits must be deposited to the PAIB reserve bank account.