CHICAGO BOARD OPTIONS EXCHANGE

Regulatory Circular RG02-91

To: Members
Member Organizations

From: Division of Regulatory Services

Date: October 30, 2002

Subject: Implications of Trading Security Futures Contracts for Market-Makers that Operate Under an Exemption From Net Capital Requirements

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KEY POINTS

- OneChicago has announced that it will begin trading security futures contracts on November 8, 2002, subject to regulatory approval.

- Options Market-Makers that are operating under the exemptive provisions of Paragraph (b)(1) of the SEC Net Capital Rule 15c3-1 (i.e., filing FOCUS Reports on a yearly basis only) are cautioned that making markets in or trading security futures contracts (or any other security that is not a CBOE listed option) in a manner that does not qualify as an options offset under risk-based haircut requirements, will lose their options market-maker exemptions and become subject to the provisions of the SEC Net Capital Rule.

- Trading security futures contracts as an offset to equity or index options market-making activity is permissible and will not result in any negative impact on an options market-maker's capital exemption.

DISCUSSION

The purpose of this Regulatory Circular is to notify members that making markets in security futures contracts or trading a security futures contract for reasons other than to hedge market–maker option activity subjects a broker–dealer to the

provisions of the Securities and Exchange Commission's ("SEC") Rule 15c3–1 ("Net Capital Rule"). In order to qualify as an options hedge, a security futures contract must be specifically recognized as such in the Net Capital Rule or Exchange margin rules

When subject to the net capital rule, broker–dealers are required to maintain at all times a specified dollar amount of regulatory capital which is established pursuant to a set formula and is dependent upon the scope of business conducted. Further, such broker–dealers are subject to, among other obligations, extensive records requirements, monthly/quarterly financial reporting to the Exchange, annual Exchange regulatory audits, as well as annual audits by independent public accountants.

Options market–makers are the only broker–dealers eligible for an exemption from the Net Capital Rule. An options market–maker is exempt from the SEC net capital requirements summarized above provided that the market–maker limits its business to options market–making transactions effected only with other broker–dealers and is not a member of the Options Clearing Corporation, among other requirements. DPMs, options specialists and stock specialist/market–makers, including market–makers in structural products, are not eligible for the exemption.

Therefore, an options market-maker would be ineligible for the exemption, and become subject to net capital requirements, if the market-maker engaged in a security futures contract transaction on more than an occasional basis. However, if the security futures contract is a recognized hedge for a related option position and is traded by the market–maker as a hedge, the options market–maker would still be entitled to a capital exemption, as noted above.

Loss of the options market–maker net capital rule exemption is a very serious matter as a broker–dealer may not lawfully conduct any business unless in net capital compliance. To conduct business when not in net capital compliance is a violation of SEC and Exchange rules and is subject to disciplinary action, as well as possible liquidation of non–market–maker positions.

Regulatory staff persons are available to assist members in gaining a better understanding of the capital implications of trading specific products. Questions regarding this memo can be directed to Richard Lewandowski (312) 786–7183 or Robert Gardner (312) 786–7937 in the Department of Financial and Sales Practice Compliance.