Regulatory Circular RG03-56

To: Market-Makers
Market-Maker Clearing Firms

From: Division of Regulatory Services

Date: July 16, 2003

Subject: Third Party Deposits Prohibited

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KEY POINTS

- On April 30, 2003, the Securities and Exchange Commission approved new CBOE Rule 4.21 – *Third Party Deposits Prohibited*. The Rule became effective on that date.

- Rule 4.21 is applicable only to member organizations that clear and carry the accounts of options market-makers ("Clearing Firms").

- The rule prohibits Clearing Firms from accepting a check, transfer of funds or transfer of securities for deposit to a broker-dealer's (e.g., market-maker's) account if drawn on an account having a different ownership name / title than the broker-dealer's account at the Clearing Firm.

- Similarly, the rule prohibits Clearing Firms from accepting physical securities for deposit to a broker-dealer's account if the securities have a different ownership name / title than the broker-dealer's account at the Clearing Firm.

DISCUSSION

Some Clearing Firms have in the past been named as defendants in legal actions brought by third parties who allege some type of impropriety with respect to funds deposited at the Clearing Firm via their check, and seek a monetary judgment against the Clearing Firm.[1] These actions are rare, and the allegations raised against the Clearing Firm are usually without merit and ultimately dismissed. However, the legal

[1] In addition to third party checks, third party deposits could also occur via a transfer of funds, as well as via a deposit or transfer of securities.

expenses of defending an arbitration claim or lawsuit are alone a significant financial risk to Clearing Firms.

Rule 4.21 was established because Clearing Firms believe that the practice of accepting third party checks / deposits has become uneconomical when the business risks are considered, and should be ended. Prohibiting the practice by rule was deemed warranted in order to ensure a uniform, safe practice across Clearing Firms.

Therefore, Rule 4.21 prohibits Clearing Firms from accepting the following for deposit to the account of a broker-dealer, including market-makers:

- checks drawn on the account of a third party,
- securities titled in the name of a third party,
- transfers of funds from the account of a third party, and
- transfers of securities from the account of a third party.

Rule 4.21 allows for exceptions to the above-listed prohibitions, as described below.

1. Clearing Firms may accept checks, funds or securities drawn on a joint account of which the broker-dealer is one of the joint owners.

2. In the case of a broker-dealer structured as a partnership or corporation, Clearing Firms may accept checks, funds or securities of any owner listed on Schedule A of the broker-dealer's Form BD. Clearing Firms may also accept checks, funds or securities of an owner listed on Schedule B of the broker-dealer's Form BD if the owner is a US broker-dealer.

3. If immediate action is required in order for the account of a broker-dealer to: (i) establish a positive net liquidating equity or supplement equity when required based upon the Clearing Firm's internal risk control procedures, or (ii) achieve compliance with SEC Rule 15c3-1 (the Net Capital Rule), an officer or partner of the Clearing Firm may make an exception to the prohibitions, that must be in writing.

4. In the case of accounts it clears and carries, Clearing Firms may transfer funds and/or securities between different name accounts provided written authorization is obtained from the owner of the account from which the funds and/or securities would be withdrawn. This exception is intended to accommodate recurring business transactions such as seat lease payments or floor brokerage fees. Clearing firms are expected to have supervisory procedures for approving transfers.

Checks of a third party that is a broker-dealer, futures commission merchant or member of a futures exchange that clearly constitute a return of funds as the result of an out-trade or other trade adjustment, are not deemed to be within the scope of Rule 4.21 and may be accepted.

Rule 4.21 also imposes record keeping requirements. It requires that written exceptions made by an officer or partner, and customers' written transfer authorizations, be maintained for at least three years, the first two in an easily accessible place.

The text of Rule 4.21 is given below. Questions regarding Rule 4.21 should be directed to James Adams at (312) 786–7718 or Richard Lewandowski at (312) 786–7183.

Chicago Board Options Exchange, Incorporated

Rules

Chapter IV

Business Conduct

Rule 4.1 through 4.20. - no change.

Third Party Deposits Prohibited

Rule 4.21. Member organizations engaged in the business of clearing and carrying the accounts of options market- makers (''Clearing Firms'') registered to conduct business on the Exchange are subject to the following prohibitions:

(1) The acceptance of a check or funds transfer for deposit into any broker-dealer account cleared or carried by a Clearing Firm is prohibited if the name on the account from which the check or transfer is drawn is not the same as that on the account cleared or carried by the Clearing Firm.

(2) The acceptance of securities, either directly or via transfer, for deposit into any broker-dealer account cleared or carried by a Clearing Firm is prohibited if the name on the securities, or the name on the account from which the securities are drawn, is not the same as that on the account cleared or carried by the Clearing Firm.

* * * Interpretations and Policies:

.01 The foregoing prohibitions do not apply to checks, funds or securities for deposit to a market-maker's account that are drawn on a joint account of which the market-maker is one of the joint owners, and the title of the market-maker's account with the Clearing Firm coincides with the market-maker's designation on the joint account.

.02 The foregoing prohibitions do not apply to checks, funds or securities for deposit into the account of a U.S. broker-dealer business entity if the depositor (i) has an ownership interest disclosed on Schedule A of the broker-dealer's Uniform Application for Broker-Dealer Registration (''Form BD''), or (ii) is a U.S. broker-dealer and has an ownership interest disclosed on Schedule B of Form BD.

.03 If immediate action is required in order for an account of a broker-dealer cleared and carried by a Clearing Firm to (i) establish a positive net liquidating equity or supplement equity when required based upon internal risk control procedures of the Clearing Firm, or (ii) achieve compliance with SEC Rule 15c3–1 (the Net Capital Rule), an officer or partner of a Clearing Firm may grant an exception, which must be in writing, with respect to any transaction prohibited by this Rule 4.21.

.04 Transfers of funds or securities between two accounts cleared and carried by the same Clearing Firm are permitted provided that, if both accounts are not owned by the same person(s) or entity, the transfer must be authorized in writing by the owner of the account from which funds and/or securities would be withdrawn.

.05 Documentation evidencing any exceptions granted pursuant to Interpretation and Policy .03 above, as well as documents authorizing transfers of funds or securities between two accounts pursuant to Interpretation and Policy .04 above, shall be retained by the Clearing Firm for at least three years, the first two years in an easily accessible place for examination by the Exchange. In lieu of having the documents easily accessible, a Clearing Firm may make and keep current a separate central log, index or other file through which the documents can be identified and retrieved.