

To: Members and Member Organizations

From: Department of Member Firm Regulation

Date: March 1, 2007

Subject: Implications of Trading Securities on CBSX for Market-Makers
that Operate Under an Exemption From Net Capital Requirements

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KEY POINTS

- ❖ CBSX has announced that it will begin trading securities on March 5, 2007.
- ❖ 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 stock (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 securities 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 stock, or the trading of stock 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 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 structured 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 stock transaction on more than an occasional basis. However, if the stock 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 Robert Gardner (312) 786-7937 in the Department of Member Firm Regulation.