



## Regulatory Circular RG10-101

Date: October 1, 2010  
To: Trading Permit Holders and TPH Organizations  
From: Member Firm Regulation  
Re: Master Accounts and Sub-Accounts

CBOE's Department of Member Firm Regulation ("DMFR") is issuing this circular to address questions that have been raised regarding proprietary trading broker-dealer organizations that are structured as limited partnerships (LPs), and/or Limited Liability Companies (LLCs), and which offer master and sub-account arrangements. Many of these firms are structured differently from traditional proprietary trading firms, which employ traders who trade the broker-dealer's capital and are paid a base salary and a performance bonus. DMFR, in its examinations of proprietary trading broker-dealer organizations, has uncovered instances where individual sub-accounts appear to be beneficially owned by persons who should be treated as customers, rather than as members/traders of the broker-dealer. These accounts should be treated as customer accounts, rather than as proprietary accounts of the broker-dealer. However, the examinations have shown that the proprietary trading firms do not treat these accounts as customer accounts, and consequently the accounts are not afforded the protections associated with customer accounts. DMFR recognizes that there are bona fide reasons to establish master/sub-account arrangements whereby some beneficial owners maintain multiple sub-accounts (for example, to employ and monitor different trading strategies, or to trade in different types of securities).<sup>1</sup>

This Regulatory Circular is applicable to both non-clearing proprietary trading broker-dealers and clearing broker-dealers. Additionally, a clearing broker-dealer is not relieved of responsibility by the mere fact that it does not offer sub-accounts. If the clearing broker-dealer is or becomes aware that its clients break an account or accounts into sub-accounts, they should review the activity as if the clearing broker-dealer was offering sub-accounts as discussed below.

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<sup>1</sup> In April 2010, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 10-18, Master Accounts and Sub-Accounts, a copy of which can be obtained through the following link: <http://www.finra.org/Industry/Regulation/Notices/2010/P121248>. Through this notice, FINRA reminded broker-dealers that maintain master/sub-account arrangements that, depending on the facts and circumstances of such arrangements, a broker-dealer may be required to recognize such sub-accounts as separate customer accounts. The broker-dealer and the sub-accounts would be subject to all federal and SRO rules respecting customer accounts.

**What the non-clearing broker-dealer should do:**

To demonstrate that persons or entities that have provided the non-clearing broker-dealer with cash are owners and not customers, the broker-dealer must do the following:

- It should have complete paperwork for all class members, including signed LLC agreements and traders agreements which provide a clear description of the relationship between the broker-dealer and trader/member and that:
  - Capital contributions must be locked-up for one year; and
  - Funds invested as capital are subject to all the risks of the broker-dealer, including risks related to other trader losses.
- The source of account funding and profit and loss split should be documented. A split which provides all or virtually all of the P & L to the trader is likely a red flag that the account is a customer account.
- The broker-dealer should monitor and supervise the activity in each account, which includes the authorization and establishment of trading privileges.
- All persons associated with the broker-dealer must complete an employment application, and all individuals associated with the broker-dealer except for those whose job functions are clerical or ministerial in nature, must be fingerprinted and have such fingerprints submitted to the Department of Justice for a criminal background check.
- The broker-dealer should conduct a pre hire check of all associated persons using the WebCRD BrokerCheck program.
- All persons associated with the broker-dealer must be appropriately registered with each SRO of which they are a member or TPH in accordance with the rule of each SRO of which they are a member.

If a review of the factors identified above (along with the guidance provided in this Regulatory Circular and FINRA Notice 10-18), lead to a conclusion that an account is not a sub-account of a proprietary trading broker-dealer organization, then the account will have to be carried as a customer account, consistent with all applicable federal and SRO regulatory requirements respecting the handling of customer accounts.

Restructuring a non-clearing proprietary trading broker-dealer to accommodate a customer business is a significant undertaking in terms of regulatory, infrastructure and operational requirements, and may not be a viable course of action.

Additionally, if a clearing broker-dealer is providing order entry/trading platform to a broker-dealer, the clearing broker-dealer should have in place adequate controls over the access to such platform by individuals associated with the broker-dealer.

Questions about this memorandum may be directed to Robert Gardner at (312) 786-7937 or Milan Markovic at (312) 786-8192.