Regulatory Circular RG-95-28

Date: April 12, 1995
To: Members
From: Regulatory Services Division
Re: Limited Extension of Market-Maker Margin Treatment for Opening Transactions Initiated Off-Floor for Hedging, Risk-Reduction or Rebalancing

On May 25, 1994, the Exchange received approval of rule amendments which grant market-makers limited ability to initiate opening transactions from off the trading floor and receive market-maker margin treatment. The purpose of this circular is to explain the amendment. The rule became effective on July 1, 1994.

BACKGROUND: Previously, under CBOE Rule 8.1, "Market-Maker Defined," only transactions initiated on the CBOE's floor counted as market-maker transactions. Thus, only on-floor market-maker transactions qualified for favorable margin treatment under the CBOE's rules, even if off-floor orders were entered to adjust or hedge the risk of positions of the market-maker that result from his on-floor market making activity. The CBOE argued that because a market-maker cannot effectively adjust his positions or engage in hedging or other risk limiting opening transactions from off the Exchange floor without incurring a significant economic penalty, CBOE market-makers must either be physically present on the floor at all times during which the market is open, or face significant risks of adverse market movements during those times when they must necessarily be absent from the trading floor. The CBOE argued that by imposing costs on certain hedging or risk-adjusting transactions of market-makers, the CBOE's current rules may prevent market-makers from effectively discharging their market making obligations and expose them to unacceptable levels of risk. The Exchange stated that its proposal was designed to accommodate the needs of market-makers occasionally to adjust or hedge options positions in their market-maker accounts at times when they are not physically present on the trading floor, without diluting the requirement that the trading activity of market-makers must fulfill their market making obligations and must contribute to the maintenance of a fair and orderly market on the Exchange.

Under CBOE Rule 8.7, Interpretation and Policy .03(b), a market-maker must execute at least 25% of his total transactions in person on the trading floor and not by entry of orders. The CBOE amended Exchange Rule 8.7 to allow market-makers who elect to meet a more stringent in-person requirement to receive market-maker margin treatment for opening transactions executed through off-floor orders. The Securities and Exchange Commission concurred with CBOE's arguments and obtained agreement from the staff of the Federal Reserve Board that no objections would be raised upon SEC approval of CBOE's amendments to its Rules 8.1 and 8.7.

QUALIFICATIONS: Whenever a Market-Maker receives Market-Maker treatment for off-floor orders pursuant to Rule 8.1, the Market-Maker becomes subject to the requirement that at least 80% of his total transactions (including closing transactions) during the same calendar quarter must be executed in person and not through the use of orders. In addition, any off-floor orders for which market-maker treatment is received **MUST** be for the purpose of hedging, reducing risk of, rebalancing or liquidating open positions of the Market-Maker. Also, all such orders must satisfy all of the other obligations imposed on Market-Makers under Rules 8.1 and 8.7, including the requirement that they be consistent with the maintenance of a fair and orderly market.

PROCEDURES: Anytime a Market-Maker initiates an order from off the trading floor the Market-Maker must specify whether the trade is to clear into his/her customer or Market-Maker account. **If the Market-Maker fails to specify which account an order is for, and the resulting transaction clears into the market-maker account, and not the customer account, it will be presumed that the Market-Maker elected market-maker margin treatment for the off-floor order.** It is the responsibility of the Market-Maker to ensure that his/her trades clear into the correct account. If a Market-Maker fails to specify which account an order is for, or specifies the incorrect account, and the clearing firm clears the trade into the Market-Maker account, then any resulting improper extension of credit will be deemed a violation by the Market-Maker of Rules 8.1 , 8.7 and Regulation X of the Federal Reserve Board where applicable. Whenever entering opening orders from off the floor Market-Makers are strongly urged to promptly verify that they clear into the correct account. Members should cause positions to be transferred promptly upon discovering that an error has occurred. (Note that if a trade is subject to margin requirements, the member has up to seven business days to deposit the necessary funds or securities.) Opening orders for a market-maker account may only be initiated by the Market-Maker. "Initiated" is defined as the ultimate decision to enter an order.

Persons receiving off-floor orders via telephone from Market-Makers continue to be required to mark the order with their initials and a "P" on the front of the order, and must mark the order as open or close customer or market-maker. Clearing firms must submit phone orders to the Trade Match Window at the end of the day. Clearing firms are reminded that they are responsible to implement adequate procedures to ensure that off-floor orders are recorded accurately and cleared into the appropriate accounts. Failure to have adequate procedures, or failure of clearing firm personnel to adhere to such procedures, may be deemed a failure to supervise by the clearing firm, a violation of Exchange Rule 4.2. If it is determined that the clearing firm knew or should have known that orders not entitled to market-maker margin treatment were being cleared into the market-maker account(s) such conduct could also be deemed a violation of Regulation T and Exchange margin rules as well. However, where a clearing firm relies in good faith upon a Market-Maker's election to receive Market-Maker margin treatment for off-floor orders, the extension of Market-Maker margin treatment to such orders will not be deemed a violation of Regulation T or Exchange margin rules even if it is subsequently determined that the Market-Maker failed to satisfy the 80% in person requirement or other requirements applicable to such orders.

RULE ENFORCEMENT: Automated surveillance will be conducted to detect patterns of activity indicative of possible improper application of Market-Maker treatment. Unusual activity will be subjected to formal investigation, and the appropriateness of specific use of Market-Maker treatment will be evaluated on a case-by-case basis. **Members are advised that improper use of Market-**

Maker margin treatment, either by persons not meeting the 80% in-person requirement and/or initiating opening off-floor orders which are not for the purpose of hedging, risk reduction or rebalancing, is a serious violation of Exchange rules. Such activity can result in significant disciplinary action, including substantial fine, suspension, revocation of the ability to receive Market-Maker margin treatment for off-floor orders, and/or other appropriate sanction. Because violations inevitably will be determined after-the-fact, retroactive deposit of customer margin is not a remedy.

To the extent that this circular is inconsistent with prior circulars this circular supersedes such prior circulars. Questions regarding this circular should be directed to Jeffrey B. Schroer, Vice President, Market Surveillance at (312) 786-7716, or to Barbara J. Casey, Vice-President, Market Regulation at (312) 786-7712.

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