

Regulatory Circular RG 96-90

Date: October 18, 1996

To: Market-Makers
Market-Maker Clearing Organizations
Joint Back Office Participants

From: Department of Financial Compliance

Re: Limitation on Non-Market-Maker Activity

Recently a number of inquiries have been made concerning the applicability of capital requirements to Exchange market-makers . This Regulatory Circular is intended to clarify the securities activities which would impose capital requirements upon Exchange members who act as options market-makers.

KEY ISSUES

-Pursuant to SEC rules, only non-clearing options market-makers can be exempt from net capital requirements.

-In accordance with SEC rules, engaging in more than an occasional non-market-maker transaction subjects the options market-maker to net capital and other regulatory requirements.

Options Market-Maker Exemption from the Net Capital Rule

CBOE Rule 8.1 defines a market-maker as an individual (either a member or nominee of a member organization) who is registered with the Exchange for the purpose of making transactions as a dealer-specialist on the floor of the Exchange in accordance with the provisions of Chapter 8. Rules 8.5 and 12.3(b)(2) describe the financial requirements for non-clearing options market-makers.

The Securities and Exchange Commission ("SEC") Uniform Net Capital Rule ("Rule 15c3-1" or "the Rule") requires that every registered broker-dealer shall at all times maintain a minimum level of net capital. Paragraph (b)(1) of the Rule sets forth an

exemptive clause which provides that certain options market-makers are not required to comply with the minimum net capital requirement. **Only non-clearing options market-makers may be exempt under paragraph (b)(1)**; Options Specialists and Designated Primary Market-Makers are subject to the Rule.

*Prohibition Against Non-Market-Making Activity

Specifically, this exemptive provision is only available to an options market-maker (i) whose securities business, except for **an occasional non-specialist related securities transaction** for its own account, is limited to that of acting as an options market-maker on a national securities exchange; (ii) that is a member in good standing and subject to the capital requirements of a national securities exchange; (iii) that transacts a business in securities solely with other broker-dealers; and (iv) that is not a member of the Options Clearing Corporation and whose securities transactions are effected through and carried by another broker-dealer.

For purposes of the Rule, options market-making includes transactions in related securities which reduce risk or hedge the broker-dealer's market-maker positions. For example, the sale of 100 shares of IBM stock against the sale of an IBM put in the course of making markets in IBM options would be considered options market-making. Unhedged trading in IBM stock alone, or active "customer" trading in another options market of multiply listed options, would not constitute options market-making.

*Occasional Investment Transactions Permitted

The Rule does permit occasional non-market-maker transactions, which are sometimes referred to as occasional investment transactions. However, there are no set parameters in the Rule relating to the number of transactions which would constitute occasional investing. The relief of this provision is intended to allow a broker-dealer to invest any excess funds which arise occasionally. It is the Exchange's position that the determination of what is occasional is a matter of judgement applied on a case-by-case basis.

Clearly, in and out speculative activity would not be considered occasional investing. Active trading in non-market-maker securities, whether effected in an options market-maker account, the related customer sub-account carried at the market-maker clearing firm, or Joint Back Office ("JBO") account¹, would not be considered occasional. Such activity would subject the member to the Rule.

Carrying non-market-maker positions in a market-maker account would not avoid

¹A Joint Back Office participant maintains a nominal ownership interest in its clearing firm. As a result the clearing firm may finance the transactions of its JBO "owner" on a more beneficial margin basis than required under Regulation T.

the application of the Rule.²

***Traditional Brokerage Accounts**

Although the Exchange has never considered securities (i.e., common and preferred stock, options, warrants, convertible and debt securities, etc.) activity in traditional brokerage accounts, such as fully margined pension or family accounts of a member, to violate the "occasional" standard, no SEC interpretation concurring with this view has been issued. In order to avoid any question with respect to such accounts, many individual members have terminated their personal broker-dealer status and become nominees of their own broker-dealer firms. In such cases, the personal trading accounts of the nominee-owner are not considered to be related to the broker-dealer business in any way, and therefore trading in such accounts has no effect on the broker-dealer's status with respect to the Capital Rule.

Loss of Market-Maker Net Capital Exemption

Should a broker-dealer initiate more than an occasional non-specialist related transaction, he may lose his exemption under paragraph (b)(1). This would cause the market-maker to be subject to, among other things, maintenance at all times of a minimum net capital, the filing with the Exchange of monthly and quarterly FOCUS reports (which include a net capital computation), an annual examination conducted by the Exchange's Department of Financial Compliance, submission of annual audited financial statements prepared by an independent accounting firm, and restrictions on capital withdrawals. Engaging in non-market-maker activity without also complying with all applicable financial responsibility requirements would be a serious matter subject to disciplinary action by the Exchange and/or the SEC.

Any questions should be directed to Richard Lewandowski in the Department of Financial Compliance at (312) 786-7183.

²Transactions in futures or future options may be effected without any impact upon the market-maker's exemption under paragraph (b)(1) of the Rule.