

Regulatory Circular RG97-71

Date: March 26, 1997

To: Members and Member Organizations

From: The Department of Financial Compliance

Subject: Capital Implications for Market-Makers Trading Structured Products

The Chicago Board Options Exchange ("CBOE") currently trades four structured products<sup>1</sup> which are subject to the same regulatory framework as stock.

**TRADING OF STRUCTURED PRODUCTS IMPOSES CAPITAL REQUIREMENTS**

The purpose of this memo is to notify members that making markets in structured products or trading a structured product 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, the structured product must be specifically recognized as such in the Net Capital Rule, Regulation T of the Federal Reserve Board 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.

As structured products, with the exception of index warrants, are considered stock for regulatory purposes, options market-makers trading these products on more than an occasional basis would be subject to capital requirements. However, if the structured product 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.

It should be noted that the SEC considers index warrants to be options for net capital purposes. Therefore, making markets in index warrants

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<sup>1</sup> The four structured products are two Smith Barney 5 year S&P 500 Link Note ("XSB" and "YSB"), Merrill Lynch Technology MITT ("TKM") and Oppenheimer 1 year S&P 500 Reset Warrant ("OPT").

would not affect a market-maker's capital status.

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.

#### **NET CAPITAL EXEMPTION FOR OPTIONS MARKET-MAKERS ONLY**

**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.

**This exemption does not apply to DPMs, options specialists and stock specialist\market-makers, including market-makers in structured products.**

#### **NOTICES TO MEMBERS**

The Exchange will make every effort to advise members of the net capital treatment of each new product in Regulatory Circulars published from time to time in the Exchange's Regulatory Bulletin and at the time a new product is allocated. Regulatory staff are available to assist members in gaining a better understanding of the capital implications of trading specific products.

## **CONCLUSION**

Questions regarding this memo can be directed to Richard Lewandowski (312) 786-7183 or Diane Malley (312) 786-7924 in the Department of Financial Compliance. For a more detailed description of the options market-maker exemption and trading activity that may disqualify a market-maker from use of the exemption, see Exchange Regulatory Circular RG96-90.

(RG97-40 Reissued)