Regulatory Circular RG00-106

DATE:	July 11, 2000
TO:	Members and Member Organizations
FROM:	Division of Regulatory Services
SUBJECT:	Joint Back Office Arrangements / Requirements Effective August 28, 2000

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KEY ISSUES

- A Joint Back Office ("JBO") arrangement is one in which a clearing broker-dealer ("JBO clearing firm") sells a nominal ownership interest in non-voting stock to a participating broker-dealer ("JBO participant"). This ownership position allows the JBO clearing firm to finance securities transactions of the JBO participant on a good faith margin basis and to not apply full customer margin requirements of Regulation T and the self-regulatory organizations ("SROs").

- The CBOE in conjunction with other SROs and industry representatives has established reasonable standards for JBO clearing firms and participants. These standards will permit good faith credit to be extended to clearing firm "owners" only when the owner maintains meaningful assets on deposit at the JBO clearing firm and the clearing firm maintains sufficient net capital and risk control procedures to carry such accounts.

- As previously published in Regulatory Circular RG00-59, Exchange rules codifying the requirements for JBO clearing firms and JBO participants become effective on **August 28, 2000**. All members and member organizations with JBO relationships must be in compliance with the requirements on that date.

- If, on the effective date, a JBO clearing firm or JBO participant fails to meet the requirements, the JBO participant's account must be margined as customer in accordance with Regulation T and the Exchange's margin rules. No exception, or "grandfather" provision, is allowed for pre-existing JBO arrangements.

- A JBO participant must:

    - be a registered broker-dealer pursuant to Section 15 of the Securities Exchange Act of 1934, and subject to Rule 15c3-1 thereunder;[1]

    - meet the ownership standards established by the JBO clearing firm;

    - maintain a minimum liquidating equity of $1 million with each clearing firm where a JBO account is carried (Multiple accounts with the same clearing firm, whether or not JBO accounts, may be aggregated for purposes of the $1 million liquidating equity provided that the beneficial ownership is exactly the same as the JBO participant account.[2] If the liquidating equity falls below the required $1 million, the JBO participant must cover the deficiency within 5 business days or lose its JBO status and become subject to the customer margin requirements of Regulation T and SRO margin requirements);

    - employ or have access to a qualified Series 27 principal; and[3]

    - contact the Department of Financial and Sales Practice Compliance to determine its financial records and reporting requirements, if not now computing and reporting net capital.

- A JBO clearing firm must:

    - establish ownership standards for JBO accounts;

    - maintain a minimum of $25 million in tentative net capital or, if the JBO clearing firm's primary business is clearing options market-maker accounts, $7 million in net capital[4] (A clearing firm will be deemed to conduct a primary options market-maker business if at least 60% of the sum of its gross haircuts calculated for all options market-maker and JBO accounts is attributable to options market-maker transactions.);

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[1] Rule 15c3-1 deals with financial responsibility and imposes net capital requirements on broker-dealers.

[2] A JBO participant's ownership interest in a joint account may be considered for purposes of the one million dollar net liquidating equity requirement provided the joint account owner is the exact same entity as the JBO participant, there exists a written agreement specifying the JBO participant's percentage of equity in the joint account, and the JBO participant would receive the equity percentage upon liquidation of the joint account.

[3] Exchange Rule 3.6A(a) requires each CBOE member subject to Rule 15c3-1 to designate and register with the CBOE a Series 27 qualified individual as a Financial/Operations Principal ("FINOP") to be responsible for ensuring the accuracy and timeliness of the firm's financial records and net capital computations, and Exchange submissions. The FINOP may be a full-time employee of the member, or with the prior written approval of the Exchange, a part-time employee or independent contractor of the member. Therefore, in order to comply with Exchange Rule 3.6A(a), the meaning of the term "have access to" is limited to contracting the services of a Series 27 qualified individual.

[4] The term "tentative net capital" generally refers to net capital before haircuts and undue concentration charges on proprietary securities positions. The term "net capital" is defined in Rule 15c3-1 is generally calculated by deducting illiquid assets from a firm's "net worth" as determined under Generally Accepted Accounting Principles (GAAP), adding to that amount properly subordinated debt under Appendix D of the Rule and further deducting haircuts from securities held in the firm's proprietary accounts.

- provide prompt written notification to the DEA if its tentative net capital or net capital, whichever applies, falls below the prescribed requirements;

- resolve any net capital deficiency within three business days or cease to accept new transactions through the JBO arrangement;[5]

- implement and maintain a written risk analysis methodology for assessing the amount of credit extended to each JBO participant; and

- deduct from its net capital each JBO participant's haircut requirement in excess of the equity maintained in the JBO participant's account.

DISCUSSION

On February 24, 2000, the Securities and Exchange Commission approved a rule filing by the CBOE that establishes equity and net capital requirements for joint back office ("JBO") arrangements. Similar rule filings by the New York Stock Exchange, American Stock Exchange, Philadelphia Stock Exchange, Pacific Stock Exchange, and Chicago Stock Exchange were simultaneously approved. The approved rule filing provided for a phase-in period of six months from the date of SEC approval.

The standards established by the rule will permit the JBO clearing firm to extend good faith credit to a JBO participant that maintains meaningful assets on deposit at the JBO clearing firm and the JBO clearing firm maintains sufficient net capital and risk control procedures to carry such accounts.

Each JBO participant must be a registered broker-dealer subject to the net capital requirements prescribed by SEC Rule 15c3-1 ("net capital rule"). JBO participants will not be able to claim an exemption available to options market-makers under SEC Rule 15c3-1 (b)(1). Furthermore, each JBO participant must deposit and maintain net liquidating equity of $1 million and meet the ownership requirements established by the JBO clearing firm. The $1 million account equity requirement must be exclusive of the JBO participant's ownership interest in the clearing firm. Finally, JBO participants must employ or have access to a Series 27 qualified and registered individual who is to be responsible for ensuring the accuracy and timeliness of the firm's financial records and net capital computations, and Exchange submissions.

JBO participants should note that being subject to the net capital rule requires them to maintain a minimum level of net capital and to be in compliance at all times. The SEC has interpreted "at all times" to include at all times during the business day. JBO participants will be subject to monthly FOCUS Report filings with the Exchange's Department of Financial and Sales Practice Compliance (the

[5] This is consistent with the New York Stock Exchange's JBO rules. See SEC Release No. 34-42453; File Nos. SR-NYSE-97-28, SR-CBOE-97-58, SR-PHLX-97-56, SR-PCX-97-49, SR-CHX-98-12, SR-AMEX-99-26. 65 FR 11620, dated March 3, 2000.

"Department") as well as subject to an annual examination. The JBO participant will also be subject to an annual audit by an independent accountant. Each JBO participant that is not currently capital computing should contact the Department to further discuss its reporting requirements.

JBO clearing firms must, among other matters, maintain a minimum of $25 million in tentative net capital or, if the firm's primary business is clearing options market-maker accounts, $7 million in net capital.[6] The firm may fall below the $25 million or $7 million requirement, whichever is applicable, for a period of time not to exceed three consecutive business days. If a deficiency still exists after the 3rd consecutive business day, the firm is prohibited from margining new transactions on a JBO basis.

Questions regarding this circular may be directed to Rich Lewandowski (312) 786-7183 or Robert Gardner (312) 786-7937, in the Exchange's Department of Financial and Sales Practice Compliance.

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[6] For purposes of these JBO requirements, a clearing firm will be deemed to be primarily engaged in the business of clearing options market-maker accounts, and eligible for the $7 million net capital requirement, if at least 60% of the sum of its gross haircuts calculated for all options market-maker and JBO accounts is attributable to options market-maker transactions. The gross haircuts calculated for JBO participants are to be added to the market-maker gross haircuts when computing gross haircuts to net capital ratios under the net capital rule.