Regulatory Circular RG 01-47

Date: **April 9, 2001**
(Reissued)

To: **All Members, Registered Options Principals, Compliance Directors**

From: **Regulatory Services Division**

Re: **Irrevocable Exercise and Short Sale Requirements**

This Circular addresses questions that members have presented to the Exchange concerning trading strategies related to selling a security long concurrent with or subsequent to the purchase of a call option on the underlying security and exercising such option. In the hypothetical situation, a firm desires to facilitate a customer who wishes to effect a transaction in an in-the-money call option series. After purchasing a call option from the customer, the firm will exercise the call and enter an order to sell the underlying security long, assuming no pre-existing short position in the stock. To the extent the firm cannot sell the security at the desired price level, the firm would desire to rescind its exercise notice in order to avoid being long the stock.

The Exchange wishes to remind members of the short sale requirements of Rule 10a-1 (the "SEC Rule") under Section 10(a) of the Securities Exchange Act of 1934 (the "Act"), which have been codified with respect to sales effected on the CBOE in CBOE Stock Rule 30.20 (the "CBOE Rule"). This circular discusses those requirements only with respect to the scenario as outlined above; it is not meant to be all-inclusive. For a more complete discussion of Short Sale Requirements, see the Securities Exchange Act of 1934.

Briefly, SEC Rule 10a-1 provides that an individual or entity, whether member or non-member, with no prior short position in the underlying security, who wishes to create for sale an immediate long position may concurrently acquire a call option and irrevocably exercise it, provided that the option purchase and exercise occur concurrently with or prior to the entry of the order to sell the underlying security. However, to sell the security long the option **must be irrevocably exercised**; the **exercise cannot be rescinded**. Should the order to sell the underlying security not be filled in its entirety, the individual or entity who entered the order cannot rescind that portion of the entered exercise to create an exercise equal to the number of shares sold.

Applied to the hypothetical scenario outlined in the first paragraph of this Circular, once the firm and customer enter into an option transaction and the options are exercised in order to sell stock long, **no portion of the option trade may later be broken ("busted")**. The Exchange realizes that a firm and/or customer may be left with a portion of their stock sale order unexecuted due to adverse movement in the underlying; however, the parties cannot resolve this situation by "busting" a portion of the option trade. The Exchange would consider such action a violation of the Short Sale Rule. Apparent violations will be investigated by the Exchange's Regulatory Services Division, Department of Market Regulation, and may result in formal disciplinary action by the Exchange's Business Conduct Committee ("BCC") or referral to the Securities and Exchange Commission ("SEC").

Questions regarding this Circular may be addressed to Margaret E. Williams, Vice-President, Department of Market Regulation, at (312) 786-7834, or Michael G. Felty, Manager, Department of Market Regulation, at (312) 786-7504.

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