

Regulatory Circular RG96-32

Date: April 10, 1996

To: Members

From: The Regulatory Services Division

Re: Market-Maker Use of Orders/
Floor Broker Representation of Market-Maker Orders

The following is the Chicago Board Options Exchange's (CBOE) policy with regard to procedures for entering and executing Market-Maker orders from both on and off the trading floor. This Circular summarizes existing rules and policies; however, it is not all inclusive and does not supplant existing CBOE Rules and Interpretations as published in the CBOE Rule Book. Members are expected to be familiar with CBOE Rules governing entry of orders and the Federal Reserve Board's regulations and SEC and CBOE Rules regarding margin treatment. Applicable rules and circulars are listed at the end of this circular.

This Circular is divided into four sections. The first section summarizes general policies concerning Market-Makers and their use of orders. The second section summarizes Market-Makers' responsibilities when entering orders for their accounts while on the trading floor. The third section summarizes Market-Makers' responsibilities for entering orders from off the trading floor and the fourth section summarizes Floor Brokers' responsibilities regarding representation and execution of orders entered by Market-Makers from on or off the trading floor.

SECTION I-GENERAL POLICY

Capital and Margin Treatment:

Market-Makers receive favorable margin and capital treatment under CBOE, SEC and Federal Reserve Board Rules. This favorable treatment is given to Market-Makers in order to aid the Market-Maker in fulfilling his obligation to maintain a fair and orderly market in securities in which he deals. Only option/warrant transactions and transactions in underlying securities or related instruments ("permitted offsets") initiated by a Market-Maker in performance or furtherance of his market function are entitled to this favorable treatment. Routinely, stock baskets associated with high-cap broad based market index options are not considered permitted offsets; although limited basket offsets exist for certain non-high-cap and narrow based index options. Permitted offsets are specifically defined in FRB Reg T Section 220.12 and in various no-action letters issued by the SEC Division of Market Regulation.

Who May Initiate Orders for a Market-Maker Account:

Only a Market-Maker on a seat may initiate an order for his Market-Maker account. The term "initiated" has been interpreted as meaning the making of the investment decision in connection with the execution of a transaction or obtaining of a position or the entry or cancellation of an order. Clerks and other members or non-members may not initiate orders for a Market-Maker's

account. Inactive nominees do not have membership status and may not enter orders for a Market-Maker account.

The use of sub-accounts to facilitate trading in a Market-Maker account by a non-member is strictly prohibited. Initiating trades for a joint account in which you are not a registered participant is also prohibited. The acronym of the joint account and the acronym of the joint account initiator must be on every order. For further information regarding use of orders by joint accounts see RG 95-64 and RG96-28. Equity or debt financing of a Market-Maker's account does not entitle the financier to initiate trades in that account.

Organizations which clear Market-Makers are advised that they have a responsibility to ensure that positions to which they extend market-maker credit and capital treatment are the result of bona-fide market-maker activity. (See Section on MARKET-MAKER ORDERS ENTERED FROM "OFF THE TRADING FLOOR" for the organizations' specific responsibilities and procedures.)

Floor Broker Representation of Orders:

As noted above, Floor Brokers may not initiate orders for a market-maker account. Additionally, Floor Brokers may not hold orders which give them discretion as to the choice of class, the number of contracts to be executed or whether such transaction shall be a purchase or sale. Floor Brokers may also not hold simultaneously a "not held" market order to buy and a "not held" market order to sell (or orders which have the effect of such "not held" market orders to buy and to sell) in the same series of options for the same beneficial owner, as this would, in effect, be giving the Floor Broker discretion respecting whether to purchase or sell the option and would be orders capable of being crossed. *All trades must be done in open outcry and a Floor Broker must make reasonable efforts to make as many members as possible aware of his bid or offer. When a Floor Broker effects a transaction for a Market-Maker via order, the Market-Maker is required to respond to any call for Market-Makers in the subject option class for the remainder of the trading day.*

Market-Maker Accounts being Represented by More than One Broker:

No Market-Maker, for any account in which he has an interest, shall maintain with more than one Floor Broker orders for the purchase or sale of the same option contract or other security or the same combination of option contracts, with the exception that joint accounts may be dually represented by Floor Brokers in OEX/SPX as long as different joint account participants initiated the orders. (See RG95-64 for a complete explanation of Joint Account Trading in OEX/SPX and RG96-28 for a complete explanation of Joint Account Trading in Equities.)

SECTION II-MARKET MAKER ORDERS ENTERED FROM "ON THE TRADING FLOOR"

Orders initiated by a Market-Maker while on the trading floor are entitled to favorable margin treatment under CBOE Rule 12.3. "On the floor" means that the Market-Maker is physically present on the trading floor at the time he initiates the order and that he is present on the trading floor during the time the order is being represented with only limited absences of short duration. The trading floor does NOT include the Members' Lounge or any other area outside the secured area of the trading floor. If a Market-Maker initiates an order while on the floor and

at some later time decides to leave the floor for an extended period of time, the order, if executed, would be considered to have been initiated from off the floor. It is the Market-Maker's responsibility to either cancel the order or to ensure that the proper margin treatment is extended to the transaction. Orders initiated from off the floor by a Market-Maker who elects to receive Market-Maker treatment for off-floor orders under Rule 8.1 is 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 that any off floor orders must be for the purpose of hedging, reducing risk of, rebalancing or liquidating open positions of the Market-Maker.

A Market-Maker must have a written record of all orders initiated by him in his possession at all times such order is active. If a Market-Maker clerk writes up an order at the direction of his employer, the Market-Maker clerk must give the Market-Maker a copy of the order before it is delivered for execution. (See Rule 6.20). If a Market-Maker enters an order via phone to a clerk other than his employee or hand signals or phones an order directly to a Floor Broker in a trading crowd the Market-Maker must immediately record the order information and maintain that written record for as long as the order is active. If hand signals are used by a Market-Maker to enter an order, the order must also be relayed to the Floor Broker in written form immediately thereafter with the exception that in OEX and SPX hand signalled orders do not have to be relayed to the Floor Broker in written form; however, a written record must be maintained by the initiating member for as long as the order is active.

SECTION III-MARKET MAKER ORDERS ENTERED FROM "OFF THE TRADING FLOOR"

When a Market-Maker initiates an order from off the trading floor the Market-Maker must specify whether the trade is to clear into his 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. 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.** Note that if a Market-Maker enters an order from off the floor, the Market-Maker must maintain a written record of the order for as long as the order is active.

It is the responsibility of the Market-Maker to ensure that his 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 must promptly verify that they clear

into the correct account. Market-Makers must direct their clearing firm to transfer positions promptly upon discovering that an error has occurred.

Persons receiving off floor orders via telephone must mark the order with their initials and place a "P" on the front of the order and mark the order open/close and customer(C), firm (F), market-maker (MM) or broker/dealer (B). Market-Maker orders must be identified as such by marking "MM" on the order ticket and recording the Market-Maker acronym in the optional data section. Firms are responsible for establishing procedures and training personnel to ensure that off floor orders are recorded accurately and cleared into the appropriate accounts. Failure to have adequate procedures and/or supervise staff is a violation of Rule 4.2. If it is determined that a clearing firm knew or should have known that orders not entitled to market-maker margin treatment were cleared into a Market-Maker account, the clearing firm may be charged with a violation of CBOE margin rules and Regulation T of the Federal Reserve Board. 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 CBOE margin rules by the clearing firm even if it is subsequently determined that the Market-Maker failed to satisfy the 80% in person requirement.

SECTION IV-FLOOR BROKER OBLIGATIONS FOR EXECUTING MARKET-MAKER ORDERS

Floor Brokers representing an order (the "original order"), may solicit a Market-Maker or member organization or a non-member customer or broker/dealer prior to or after disclosing the original order to a CBOE trading crowd. All orders initiated as a result of a solicitation must be marked "SL" and if the solicited person is on the trading floor and elects to participate by order, the solicited person must retain a copy of the solicited order so long as the order is active. Solicited orders include "facilitation" orders. A solicited order gains priority over the crowd only if the terms of the original order are disclosed to the crowd prior to solicitation, the original order is continuously represented, and the solicited order betters the market and matches the original order bid or offer. All three of these conditions must be met for the solicited order to take priority over the crowd. (See Rule 6.9).

Floor Brokers are required to use due diligence to execute all orders at the best available price. Pursuant to Rule 6.73(a), a Floor Broker's use of due diligence in executing an order shall include making reasonable efforts to make as many members as possible aware of his bid or offer. Every Floor Broker who represents a Market-Maker order shall, by public outcry at the post, indicate the identity of such Market-Maker at the request of the OBO or any member (See Rule 7.5). Crossing orders "silently" is strictly prohibited--all orders must be executed in open outcry. Market-Maker orders that are for less than ten contracts and are represented in the crowd by a Floor Broker should not be reflected in the displayed market quote.

If you have questions concerning this Circular, please contact the Department of Market Regulation, (312) 786-7834. Specific questions concerning the margin or capital treatment of

Market-Maker and permitted offset positions should be directed to the Department of Financial Compliance, (312) 786-7924.

Applicable Rules and Circulars:

CBOE Rules:

- 3.8(b)(2)(B)- Nominees
- 4.2- Adherence to Law
- 4.6- False Statements

- 6.9- Solicited Transactions
- 6.20- Admission to and Conduct on the Trading Floor
- 6.22- Trading by Members on the Floor
- 6.24- Orders Required to Be in Written Form
- 6.45- Priority of Bids and Offers
- 6.55- Multiple Orders Prohibited
- 6.75- Discretionary Transactions
- 7.5- Obligation for Fair and Orderly Market
- 8.1- Market-Maker Defined
- 8.7- Obligations of Market-Makers
- 8.9- Securities Accounts and Orders of Market-Makers
- 8.51- Trading Crowd Firm Disseminated Market Quotes
- 12.3- Margin Requirements
- 24.11- Margins

Reg Circulars:

- 90-44-Joint Account
Order ID
- 96-28-Joint Acct.
in Equities

- 94-40-Limited Ex.
MM Margin
- 94-42-Use of Sub-
Accounts
- 95-64-Joint Account
Trading in
OEX/SPX

Applicable Federal Reserve Board and SEC Regulations are FRB Reg T Sections 220.4 220.5 and 220.12 and FRB Reg X and SEC Rule 15c3-1.