

## OMB APPROVAL

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Page 1 of 43

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 19b-4

File No. SR - 2007 - 106

A self-regulatory organization

Proposed Rule Change by Chicago Board Options Exchange

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial <input checked="" type="checkbox"/>	Amendment <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) <input checked="" type="checkbox"/>	Section 19(b)(3)(A) <input type="checkbox"/>	Section 19(b)(3)(B) <input type="checkbox"/>
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Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action <input type="checkbox"/>
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<input type="checkbox"/> Temporary	<input type="checkbox"/> Indefinite
<input type="checkbox"/> 12 months	<input type="checkbox"/> 24 months
<input type="checkbox"/> 36 months	<input type="checkbox"/> 48 months

**Description**

Provide a brief description of the proposed rule change (limit 250 characters).

Amends CBOE rules governing doing business with the public.

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name	Jaime	Last Name	Galvan
Title	Assistant Secretary		
E-mail	galvanj@cboe.com		
Telephone	(312) 786-7058	Fax	(312) 786-7919

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 09/06/2007

By Jaime Galvan

(Name)

Assistant Secretary

(Title)

NOTE: Clicking the button at right will digitally sign and lock  
this form. A digital signature is as legally binding as a physical  
signature, and once signed, this form cannot be changed.

Jaime Galvan, galvanj@cboe.com

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFT website.

**Form 19b-4 Information**

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change**

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

Exhibit Sent As Paper Document

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

Exhibit Sent As Paper Document

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

Item 1. Text of the Proposed Rules Changes

Chicago Board Options Exchange, Incorporated (the "CBOE" or "Exchange") proposes to amend certain Exchange rules that govern an Exchange member's conduct of doing business with the public. Specifically, the proposed rule change would require member organizations to integrate the responsibility for supervision of a member organization's public customer options business into its overall supervisory and compliance program. In addition, the Exchange proposes to amend certain rules to strengthen member organizations' supervisory procedures and internal controls as they relate to a member's public customer options business. The text of the proposed rule change is attached as Exhibit 5.

Item 2. Procedures of the Self-Regulatory Organization

The proposed rule changes were approved by the Office of the Chairman pursuant to delegated authority on September 5, 2007. No further action is required.

Item 3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

I. Integration of Options Supervision

The purpose of the proposed rule change is to create a supervisory structure for options that is similar to that required by New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD") rules<sup>1</sup>. The proposed rule change would eliminate the requirement that member organizations qualified to do a public customer business in options must designate a single person to act as Senior Registered Options Principal ("SROP") for the member organization and that each such member organization designate a specific individual as a Compliance Registered Options Principal ("CROP"). Instead member organizations would be required to integrate the SROP and CROP functions into their overall supervisory and compliance programs.

The SROP concept was first introduced by CBOE during the early years of the development of the listed options market. Previously, under CBOE rules, member organizations were required to designate one or more persons qualified as Registered Options Principals ("ROPs") having supervisory responsibilities in respect of the member organization's options business. As the number of ROPs at larger member organizations began to increase, CBOE imposed an additional requirement that member organizations designate one of their ROPs as the SROP. This was intended to eliminate confusion as to where the compliance and supervisory responsibilities lay by centralizing in a single supervisory officer overall responsibility for the supervision of a member organization's options activities.<sup>2</sup> Subsequently, following the recommendation of the Commission's Options Study, CBOE and other options exchanges required member organizations to designate a CROP to be responsible for the member organization's overall compliance program in respect of its options activities.<sup>3</sup> The CROP may be the same person who is designated as SROP.

Since the SROP and CROP requirements were first imposed, the supervisory function in respect of the options activities of most securities firms has been integrated into the matrix of supervisory and compliance functions in respect of the firms' other securities activities. This not only reflects the maturity of the options market, but also recognizes the ways in which the uses of options themselves have become more integrated with other securities in the implementation of particular strategies. Thus, the current requirement for a separately designated senior supervisor in respect of all aspects of a member organization's options activities, rather than clarifying the allocation of supervisory responsibilities within the member organization, may have just the opposite effect by failing to take into account the way in which these responsibilities are actually

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<sup>1</sup> See NYSE Rule 342 and NASD Rule 3010.

<sup>2</sup> Report of the Special Study of the Options Market ("Options Study"), note 11 p.316 (December 22, 1978).

<sup>3</sup> Id at p. 335.

assigned. In addition, by permitting supervision of a member organization's options activities to be handled in the same manner as the supervision of its other securities and futures activities, the proposed rule change will ensure that supervisory responsibility over each segment of the member organization's business is assigned to the best qualified persons in the member organization, thereby enhancing the overall quality of supervision. The same holds true for the compliance function.

For example, most member organizations have designated one person to have supervisory responsibility over the application of margin requirements and other matters pertaining to the extension of credit. The proposed rule change would enable a member organization to include within the scope of such a person's duties the supervision over the proper margining of options accounts, thereby assuring that the most qualified person is charged with this responsibility and at the same time eliminating any uncertainty that might now exist as to whether this responsibility lies with the senior credit supervisor or with the SROP.

Similarly, the proposed rule change would allow a member organization to specifically designate one or more individuals as being responsible for approving a ROP's acceptance of discretionary accounts<sup>4</sup> and exceptions to a member organization's suitability standards for trading uncovered short options<sup>5</sup>. The proposed rule changes would allow member organizations the flexibility to assign such responsibilities, which formerly rested with the SROP and/or CROP, to more than one ROP qualified individual where the member organization believes it advantageous to do so to enhance its supervisory or compliance structure. Typically, a member organization may wish to divide these functions on the basis of geographic region or functional considerations. Rule 9.2 would be amended to clarify the qualification requirements of

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<sup>4</sup> See proposed Rule 9.10(a).

<sup>5</sup> See proposed Rule 9.7(f)(3).

individuals designated as ROPs.<sup>6</sup> Rule 9.3 would be amended to specify the registration requirements of individuals who accept orders from non-broker-dealer customers.<sup>7</sup>

The proposed rule change would call for options discretionary accounts, the acceptance of which must be approved by a ROP qualified individual (other than the ROP who accepted the account), to be supervised in the same manner as the supervision of other securities accounts that are handled on a discretionary basis. The proposed rule change would eliminate the requirement that discretionary options orders be approved on the day of entry by a ROP (with one exception as described below). This requirement predates the Options Study and is not consistent with the use of supervisory tools in computerized format or exception reports generated after the close of a trading day. No similar requirement exists for supervision of other securities accounts that are handled on a discretionary basis.<sup>8</sup> Discretionary orders must be reviewed in accordance with a member organization's written supervisory procedures. The proposed rule change would ensure that supervisory responsibilities are assigned to specific ROP-qualified individuals, thereby enhancing the quality of supervision.

Exchange Rule 9.10 would be revised by adding, as Interpretation and Policy .01, a requirement that any member organization that does not utilize computerized surveillance tools for the frequent and appropriate review of discretionary account activity must establish and implement procedures to require ROP qualified individuals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered. The Exchange believes that any member organization that does not utilize computerized surveillance tools to monitor discretionary account activity should continue to be required to perform the daily manual review of discretionary orders.

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<sup>6</sup> See proposed Rules 9.2.01 and 9.2.02.

<sup>7</sup> See Proposed Rule 9.3.01.

<sup>8</sup> See, e.g., NYSE Rule 408.

Under the proposed rule change, options discretionary accounts will continue to receive frequent appropriate supervisory review by designated ROP-qualified individuals. Additionally, member organizations will continue to be required to designate ROP-qualified individuals to review and approve the acceptance of options discretionary accounts in order to determine whether the ROP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the proposed strategies or transactions. This requirement provides an additional level of supervisory audit over options discretionary accounts that does not exist for other securities discretionary accounts.

In addition, the proposed rule change would require that each member organization submit to the Exchange a written report by April 1 of each year, that details the member organization's supervision and compliance effort, including its options compliance program, during the preceding year and reports on the adequacy of the member organization's ongoing compliance processes and procedures.<sup>9</sup>

Proposed Rule 9.8(h) would require that each member organization submit, by April 1<sup>st</sup> of each year, a copy of the Rule 9.8(g) annual report to one or more of its control persons or, if the member organization has no control person, to the audit committee of its board of directors or its equivalent committee or group.<sup>10</sup>

Proposed Rule 9.8(g) would provide that a member organization that specifically includes its options compliance program in a report that complies with substantially similar requirements of the NYSE and NASD will be deemed to have satisfied the requirements of Rules 9.8(g) and 9.8(h).

Additionally, where appropriate, the proposed rule change would delete references to SROP and CROP in Rules 3.6A and 26.10.<sup>11</sup>

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<sup>9</sup> See proposed Rule 9.8(g), which is modeled after NYSE Rule 342.30.

<sup>10</sup> Proposed Rule 9.8(h) is modeled after NYSE Rule 354.

<sup>11</sup> The Exchange notes that a separate proposed rule change currently pending at the Commission (SR-

Although the proposed rule change would eliminate entirely the positions and titles of the SROP and CROP, member organizations would still be required to designate a single general partner or executive officer to assume overall authority and responsibility for internal supervision, control of the member organization and compliance with securities laws and regulations.<sup>12</sup> Member organizations would also be required to designate specific qualified individuals as having supervisory or compliance responsibilities over each aspect of the member organization's options activities and to set forth the names and titles of these individuals in their written supervisory procedures.<sup>13</sup> This is consistent with the integration of options supervision into the overall supervisory and compliance structure of a member organization. In connection with the approval of these proposed rule changes, the Exchange intends to review member organizations' written supervisory and compliance procedures in the course of the Exchange's routine examination of member organizations to ensure that supervisory and compliance responsibilities are adequately defined.

The Exchange believes that the proposed rule changes recognize that options are no longer in their infancy, have become more integrated with other securities in the implementation of particular strategies, and thus should not continue to be regulated as though they are a new and experimental product. The Exchange believes that the proposed rule change is appropriate and would not materially alter the supervisory operations of member organizations. The Exchange believes the supervisory and compliance structure in place for non-options products at most member organizations is not materially different from the structure in place for options.

## II. Supervisory Procedures and Internal Controls

The Exchange also proposes to amend certain rules to strengthen member and member organizations' supervisory procedures and internal controls as they relate to a member's public customer options business. The proposed rule changes described below are modeled after NYSE

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CBOE-2007-30) proposes to delete references to the CROP in Rule 9.21, among other things.

<sup>12</sup> See proposed Rule 9.8(a).

and NASD rules approved by the Commission in 2004.<sup>14</sup> The Exchange believes the following proposal to strengthen member supervisory procedures and internal controls is appropriate and consistent with the preceding proposal to integrate options and non-options sales practice supervision and compliance functions.

Exchange Rule 9.8(a)(3) would be revised to require the development and implementation of written policies and procedures reasonably designed to supervise sales managers and other supervisory personnel who service customer options accounts (i.e., who act in the capacity of a registered representative).<sup>15</sup> This requirement would apply to branch office managers, sales managers, regional/district sales managers, or any person performing a similar supervisory function. Such policies and procedures are expected to encompass all options sales-related activities. Proposed Rule 9.8(a)(3)(i) would require that supervisory reviews of producing sales managers be conducted by a qualified ROP who is either senior to, or otherwise "independent of", the producing manager under review.<sup>16</sup> This provision is intended to ensure that all options sales activity of a producing manager is monitored for compliance with applicable regulatory requirements by persons who do not have a personal interest in such activity.

Proposed Rule 9.8(a)(3)(ii) would provide a limited exception for members so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the

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<sup>13</sup> See proposed Rule 9.8.01.

<sup>14</sup> See Securities Exchange Act Release No. 49882 (June 17, 2004), 69 FR 35108 (June 23, 2004) (SR-NYSE-2002-36), and Securities Exchange Act Release No. 49883 (June 17, 2004), 69 FR 35092 (June 23, 2004) (SR-NASD-2002-162).

<sup>15</sup> Proposed Rule 9.8(a)(3) is modeled after NYSE Rule 342.19.

<sup>16</sup> An "otherwise independent" person is defined in proposed Rule 9.8(a)(3)(i) as one who: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less. Further, if a person designated to review a producing manager receives an override or other income derived from that producing manager's customer activity that represents more than 10% of the designated person's gross income derived from the member organization over the course of a rolling twelve-month period, the member organization must establish alternative senior or otherwise independent supervision of that producing manager to be conducted by a qualified ROP other than the designated person receiving the income.

producing manager to conduct the review. In this case, the reviews may be conducted by a qualified ROP to the extent practicable. Under proposed Rule 9.8(a)(3)(iii), a member relying on the limited size and resources exception must document the factors used to determine that compliance with each of the "senior" or "otherwise independent" standards of Rule 9.8(a)(3)(i) is not possible, and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of Rule 9.8(a)(3)(i) to the extent practicable.<sup>17</sup>

Proposed Rule 9.8(c)(i) would require member organizations to develop and maintain adequate controls over each of its business activities. The proposed rule would further require that such controls include the establishment of procedures to independently verify and test the supervisory systems and procedures for those business activities. Member organizations would be required to include in the annual report prepared pursuant to Rule 9.8(g) a review of the member organization's efforts in this regard, including a summary of the tests conducted and significant exceptions identified. The Exchange believes proposed Rule 9.8(c)(i) would enhance the quality of member organizations' supervision.<sup>18</sup>

Proposed Rule 9.8(d) would establish requirements for branch office inspections similar to the requirements of NYSE Rule 342.24. Specifically, Rule 9.8(d) would require a member organization to inspect, at least annually, each supervisory branch office and inspect each non-supervisory branch office at least once every three years.<sup>19</sup> The proposed rule would further

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<sup>17</sup> Paragraph (a)(3)(iv) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rules 9.8(a)(3)(i), (a)(3)(ii) and (a)(3)(iii) will be deemed to have met such requirements.

<sup>18</sup> Proposed Rule 9.8(c)(i) is modeled after NYSE Rule 342.23. Paragraph (c)(ii) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rule 9.8(c)(i) will be deemed to have met such requirements.

<sup>19</sup> Proposed Rules 9.8(d)(1)(i) and (ii) would provide members with two exceptions from the annual branch office inspection requirement: a member may demonstrate to the satisfaction of the Exchange that other arrangements may satisfy the Rule's requirements for a particular branch office, or based upon a member organization's written policies and procedures providing for a systematic risk-based surveillance system, the member organization submits a proposal to the Exchange and receives, in writing, an exemption from this requirement pursuant to Rule 9.8(e).

require that persons who conduct a member organization's annual branch office inspection must be independent of the direct supervision or control of the branch office (i.e., not the branch office manager, or any person who directly or indirectly reports to such manager, or any person to whom such manager directly reports). The Exchange believes that requiring branch office inspections be conducted by someone who has no significant financial interest in the success of a branch office should lead to more objective and vigorous inspections.

Under proposed Rule 9.8(e), any member organization seeking an exemption, pursuant to Rule 9.8(d)(1)(ii), from the annual branch office inspection requirement would be required to submit to the Exchange written policies and procedures for systematic risk-based surveillance of its branch offices, as defined in Rule 9.8(e). Proposed Rule 9.8(f) would require that annual branch office inspection programs include, at a minimum, testing and verification of specified internal controls.<sup>20</sup> Paragraph (d)(3) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rules 9.8(d), (e) and (f) will be deemed to have met such requirements.

In conjunction with the proposed changes to Rules 9.8(d), (e) and (f), the Exchange proposes to amend Rule 9.6 to define "branch office" in a way that is substantially similar to the definition of branch office in NYSE Rule 342.10.

Proposed Rule 9.8(g)(4) would require a member organization to designate a Chief Compliance Officer (CCO).<sup>21</sup> Proposed Rule 9.8(g)(5) would require each member organization's chief executive officer (CEO), or equivalent, to certify annually that the member organization has in place processes to: (1) establish and maintain policies and procedures reasonably designed to achieve compliance with applicable Exchange rules and federal securities laws and regulations; (2) modify such policies and procedures as business, regulatory, and

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<sup>20</sup> Proposed Rules 9.8(e) and (f) are modeled after NYSE Rule 342.25 and 342.26.

<sup>21</sup> Rule 3.6A(b) is revised to add Chief Compliance Officer as a new associated person status under Chapter 9 of Exchange Rules.

legislative changes and events dictate; and (3) test the effectiveness of such policies and procedures on a periodic basis, the timing of which is reasonably designed to ensure continuing compliance with Exchange rules and federal securities laws and regulations.

Proposed Rule 9.8(g)(5) would further require that the CEO attest the CEO has conducted one or more meetings with the CCO in the preceding 12 months to discuss the compliance processes in proposed Rule 9.8(g)(5)(i), that the CEO has consulted with the CCO and other officers to the extent necessary to attest to the statements in the certification, and the compliance processes are evidenced in a report, reviewed by the CEO, CCO, and such other officers as the member organization deems necessary to make the certification, that is provided to the member organization's board of directors and audit committee (if such committee exists).<sup>22</sup>

Under proposed Rule 9.8(b)(2), a member, upon a customer's written instructions, may hold mail for a customer who will not be at his or her usual address for no longer than two months if the customer is on vacation or traveling, or three months if the customer is going abroad. This provision would help ensure that members that hold mail for customers who are away from their usual addresses, do so only pursuant to the customer's written instructions and for a specified, relatively short period of time.<sup>23</sup>

Proposed Rule 9.8(b)(3) would require that, before a customer options order is executed, the account name or designation must be placed upon the memorandum for each transaction. In addition, only a qualified ROP may approve any changes in account names or designations. The ROP also must document the essential facts relied upon in approving the changes and maintain the record in a central location. A member would be required to preserve any account designation change documentation for a period of not less than three years, with the documentation preserved for the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4. The Exchange believes the proposed rule would help to protect account name

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<sup>22</sup> Proposed Rule 9.8(g)(5) is modeled after NASD Rule 3013 and NYSE Rule 342.30(e).

and designation information from possible fraudulent activity.<sup>24</sup>

Rule 9.10(d) allows member organizations to exercise time and price discretion on orders for the purchase or sale of a definite number of options contracts in a specified security. The Exchange proposes to amend Rule 9.10(d) to limit the duration of this discretionary authority to the day it is granted, absent written authorization to the contrary. In addition, the proposed rule would require any exercise of time and price discretion to be reflected on the customer order ticket. The proposed one-day limitation would not apply to time and price discretion exercised for orders effected with or for an institutional account (as defined in the rule) pursuant to valid Good-Till-Cancelled instructions issued on a “not held” basis. The Exchange believes that investors will receive greater protection by clarifying the time such discretionary orders remain pending.<sup>25</sup>

#### Statutory Basis

The proposed rule change would integrate the supervision and compliance functions relating to member organizations' public customer options activities into the overall supervisory structure of a member organization, thereby eliminating any uncertainty over where supervisory responsibility lies. The proposed rule change would also foster the strengthening of members' and member organizations' internal controls and supervisory systems. As such, the proposed rule changes are consistent with and further the objectives of Section 6(b)(5)<sup>26</sup> of the Act, in that they are designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and in general, to protect investors and the public interest.

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<sup>23</sup> Proposed Rule 9.8(b)(2) is modeled after NASD Rule 3110(i).

<sup>24</sup> Proposed Rule 9.8(b)(3) is modeled after NASD Rule 3110(j).

<sup>25</sup> Proposed Rule 9.10(d) is modeled after NASD Rule 2510(d)(1).

<sup>26</sup> 15 U.S.C. 78f(b)(5).

Item 4. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Item 5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants and Others

No written comments were solicited or received with respect to the proposed rule changes.

Item 6. Extension of Time for Commission Action

The Exchange does not consent at this time to an extension of any time period for Commission action.

Item 7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

Item 8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or the Commission

The proposed rule changes relating to integrating options sales practice supervision into a member organization's overall supervisory and compliance programs are not based on the rules of another self-regulatory organization or the Commission. The proposed rule changes relating to supervisory procedures and internal controls are modeled after NYSE and NASD rules.<sup>27</sup>

Item 9. Exhibits

Exhibit 1      Form of Notice of Proposed Rule Change for publication in the Federal Register

Exhibit 5.      Text of Proposed Rule Change.

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<sup>27</sup> Supra Note 13.

**EXHIBIT 1**

**SECURITIES AND EXCHANGE COMMISSION**

(Release No. 34-\_\_\_\_\_; File No. SR-CBOE-2007-106)

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by Chicago Board Options Exchange, Incorporated Relating to CBOE Rules Governing Doing Business With the Public.**

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Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b)(1), notice is hereby given that on \_\_\_\_\_, Chicago Board Options Exchange, Incorporated ("CBOE" or the "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

**I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") proposes to amend certain Exchange rules that govern an Exchange member's conduct of doing business with the public. Specifically, the proposed rule change would require member organizations to integrate the responsibility for supervision of a member organization's public customer options business into its overall supervisory and compliance program. In addition, the Exchange proposes to amend certain rules to strengthen member organizations' supervisory procedures and internal controls as they relate to a member's public customer options business. The text of the proposed rule change is available on the

Exchange's website (<http://www.cboe.org/legal>), at the Exchange's Office of the Secretary and at the Commission.

## **II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. CBOE has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.

### **A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, Proposed Rule Change**

#### **I. Integration of Options Supervision**

The purpose of the proposed rule change is to create a supervisory structure for options that is similar to that required by New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD") rules<sup>1</sup>. The proposed rule change would eliminate the requirement that member organizations qualified to do a public customer business in options must designate a single person to act as Senior Registered Options Principal ("SROP") for the member organization and that each such member organization designate a specific individual as a Compliance Registered Options Principal ("CROP"). Instead member organizations would be required to integrate the SROP and CROP functions into their overall supervisory and compliance programs.

The SROP concept was first introduced by CBOE during the early years of the development of the listed options market. Previously, under CBOE rules, member

organizations were required to designate one or more persons qualified as Registered Options Principals ("ROPs") having supervisory responsibilities in respect of the member organization's options business. As the number of ROPs at larger member organizations began to increase, CBOE imposed an additional requirement that member organizations designate one of their ROPs as the SROP. This was intended to eliminate confusion as to where the compliance and supervisory responsibilities lay by centralizing in a single supervisory officer overall responsibility for the supervision of a member organization's options activities.<sup>2</sup> Subsequently, following the recommendation of the Commission's Options Study, CBOE and other options exchanges required member organizations to designate a CROP to be responsible for the member organization's overall compliance program in respect of its options activities.<sup>3</sup> The CROP may be the same person who is designated as SROP.

Since the SROP and CROP requirements were first imposed, the supervisory function in respect of the options activities of most securities firms has been integrated into the matrix of supervisory and compliance functions in respect of the firms' other securities activities. This not only reflects the maturity of the options market, but also recognizes the ways in which the uses of options themselves have become more integrated with other securities in the implementation of particular strategies. Thus, the current requirement for a separately designated senior supervisor in respect of all aspects of a member organization's options activities, rather than clarifying the allocation of

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<sup>1</sup> See NYSE Rule 342 and NASD Rule 3010.

<sup>2</sup> Report of the Special Study of the Options Market ("Options Study"), note 11 p.316 (December 22, 1978).

<sup>3</sup> *Id.* at p. 335.

supervisory responsibilities within the member organization, may have just the opposite effect by failing to take into account the way in which these responsibilities are actually assigned. In addition, by permitting supervision of a member organization's options activities to be handled in the same manner as the supervision of its other securities and futures activities, the proposed rule change will ensure that supervisory responsibility over each segment of the member organization's business is assigned to the best qualified persons in the member organization, thereby enhancing the overall quality of supervision. The same holds true for the compliance function.

For example, most member organizations have designated one person to have supervisory responsibility over the application of margin requirements and other matters pertaining to the extension of credit. The proposed rule change would enable a member organization to include within the scope of such a person's duties the supervision over the proper margining of options accounts, thereby assuring that the most qualified person is charged with this responsibility and at the same time eliminating any uncertainty that might now exist as to whether this responsibility lies with the senior credit supervisor or with the SROP.

Similarly, the proposed rule change would allow a member organization to specifically designate one or more individuals as being responsible for approving a ROP's acceptance of discretionary accounts<sup>4</sup> and exceptions to a member organization's suitability standards for trading uncovered short options<sup>5</sup>. The proposed rule changes would allow member organizations the flexibility to assign such responsibilities, which formerly rested with the SROP and/or CROP, to more than one ROP qualified individual

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<sup>4</sup> See proposed Rule 9.10(a).

where the member organization believes it advantageous to do so to enhance its supervisory or compliance structure. Typically, a member organization may wish to divide these functions on the basis of geographic region or functional considerations. Rule 9.2 would be amended to clarify the qualification requirements of individuals designated as ROPs.<sup>6</sup> Rule 9.3 would be amended to specify the registration requirements of individuals who accept orders from non-broker-dealer customers.<sup>7</sup>

The proposed rule change would call for options discretionary accounts, the acceptance of which must be approved by a ROP qualified individual (other than the ROP who accepted the account), to be supervised in the same manner as the supervision of other securities accounts that are handled on a discretionary basis. The proposed rule change would eliminate the requirement that discretionary options orders be approved on the day of entry by a ROP (with one exception as described below). This requirement predates the Options Study and is not consistent with the use of supervisory tools in computerized format or exception reports generated after the close of a trading day. No similar requirement exists for supervision of other securities accounts that are handled on a discretionary basis.<sup>8</sup> Discretionary orders must be reviewed in accordance with a member organization's written supervisory procedures. The proposed rule change would ensure that supervisory responsibilities are assigned to specific ROP-qualified individuals, thereby enhancing the quality of supervision.

Exchange Rule 9.10 would be revised by adding, as Interpretation and Policy .01, a requirement that any member organization that does not utilize computerized

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<sup>5</sup> See proposed Rule 9.7(f)(3).

<sup>6</sup> See proposed Rules 9.2.01 and 9.2.02.

<sup>7</sup> See Proposed Rule 9.3.01.

<sup>8</sup> See, e.g., NYSE Rule 408.

surveillance tools for the frequent and appropriate review of discretionary account activity must establish and implement procedures to require ROP qualified individuals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered. The Exchange believes that any member organization that does not utilize computerized surveillance tools to monitor discretionary account activity should continue to be required to perform the daily manual review of discretionary orders.

Under the proposed rule change, options discretionary accounts will continue to receive frequent appropriate supervisory review by designated ROP-qualified individuals. Additionally, member organizations will continue to be required to designate ROP-qualified individuals to review and approve the acceptance of options discretionary accounts in order to determine whether the ROP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the proposed strategies or transactions. This requirement provides an additional level of supervisory audit over options discretionary accounts that does not exist for other securities discretionary accounts.

In addition, the proposed rule change would require that each member organization submit to the Exchange a written report by April 1 of each year, that details the member organization's supervision and compliance effort, including its options compliance program, during the preceding year and reports on the adequacy of the member organization's ongoing compliance processes and procedures.<sup>9</sup>

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<sup>9</sup> See proposed Rule 9.8(g), which is modeled after NYSE Rule 342.30.

Proposed Rule 9.8(h) would require that each member organization submit, by April 1<sup>st</sup> of each year, a copy of the Rule 9.8(g) annual report to one or more of its control persons or, if the member organization has no control person, to the audit committee of its board of directors or its equivalent committee or group.<sup>10</sup>

Proposed Rule 9.8(g) would provide that a member organization that specifically includes its options compliance program in a report that complies with substantially similar requirements of the NYSE and NASD will be deemed to have satisfied the requirements of Rules 9.8(g) and 9.8(h).

Additionally, where appropriate, the proposed rule change would delete references to SROP and CROP in Rules 3.6A and 26.10.<sup>11</sup>

Although the proposed rule change would eliminate entirely the positions and titles of the SROP and CROP, member organizations would still be required to designate a single general partner or executive officer to assume overall authority and responsibility for internal supervision, control of the member organization and compliance with securities laws and regulations.<sup>12</sup> Member organizations would also be required to designate specific qualified individuals as having supervisory or compliance responsibilities over each aspect of the member organization's options activities and to set forth the names and titles of these individuals in their written supervisory procedures.<sup>13</sup> This is consistent with the integration of options supervision into the overall supervisory and compliance structure of a member organization. In connection with the approval of these proposed rule changes, the Exchange intends to review member organizations'

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<sup>10</sup> Proposed Rule 9.8(h) is modeled after NYSE Rule 354.

<sup>11</sup> The Exchange notes that a separate proposed rule change currently pending at the Commission (SR-CBOE-2007-30) proposes to delete references to the CROP in Rule 9.21, among other things.

<sup>12</sup> See proposed Rule 9.8(a).

written supervisory and compliance procedures in the course of the Exchange's routine examination of member organizations to ensure that supervisory and compliance responsibilities are adequately defined.

The Exchange believes that the proposed rule changes recognize that options are no longer in their infancy, have become more integrated with other securities in the implementation of particular strategies, and thus should not continue to be regulated as though they are a new and experimental product. The Exchange believes that the proposed rule change is appropriate and would not materially alter the supervisory operations of member organizations. The Exchange believes the supervisory and compliance structure in place for non-options products at most member organizations is not materially different from the structure in place for options.

## II. Supervisory Procedures and Internal Controls

The Exchange also proposes to amend certain rules to strengthen member and member organizations' supervisory procedures and internal controls as they relate to a member's public customer options business. The proposed rule changes described below are modeled after NYSE and NASD rules approved by the Commission in 2004.<sup>14</sup> The Exchange believes the following proposal to strengthen member supervisory procedures and internal controls is appropriate and consistent with the preceding proposal to integrate options and non-options sales practice supervision and compliance functions.

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<sup>13</sup> See proposed Rule 9.8.01.

<sup>14</sup> See Securities Exchange Act Release No. 49882 (June 17, 2004), 69 FR 35108 (June 23, 2004) (SR-NYSE-2002-36), and Securities Exchange Act Release No. 49883 (June 17, 2004), 69 FR 35092 (June 23, 2004) (SR-NASD-2002-162).

Exchange Rule 9.8(a)(3) would be revised to require the development and implementation of written policies and procedures reasonably designed to supervise sales managers and other supervisory personnel who service customer options accounts (i.e., who act in the capacity of a registered representative).<sup>15</sup> This requirement would apply to branch office managers, sales managers, regional/district sales managers, or any person performing a similar supervisory function. Such policies and procedures are expected to encompass all options sales-related activities. Proposed Rule 9.8(a)(3)(i) would require that supervisory reviews of producing sales managers be conducted by a qualified ROP who is either senior to, or otherwise "independent of", the producing manager under review.<sup>16</sup> This provision is intended to ensure that all options sales activity of a producing manager is monitored for compliance with applicable regulatory requirements by persons who do not have a personal interest in such activity.

Proposed Rule 9.8(a)(3)(ii) would provide a limited exception for members so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the review. In this case, the reviews may be conducted by a qualified ROP to the extent practicable. Under proposed Rule 9.8(a)(3)(iii), a member relying on the limited size and resources exception must document the factors used to determine that compliance with each of the "senior" or

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<sup>15</sup> Proposed Rule 9.8(a)(3) is modeled after NYSE Rule 342.19.

<sup>16</sup> An "otherwise independent" person is defined in proposed Rule 9.8(a)(3)(i) as one who: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less. Further, if a person designated to review a producing manager receives an override or other income derived from that producing manager's customer activity that represents more than 10% of the designated person's gross income derived from the member organization over the course of a rolling twelve-month period, the member organization must establish alternative senior or otherwise independent supervision of that producing manager to be conducted by a qualified ROP other than the designated person receiving the income.

"otherwise independent" standards of Rule 9.8(a)(3)(i) is not possible, and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of Rule 9.8(a)(3)(i) to the extent practicable.<sup>17</sup>

Proposed Rule 9.8(c)(i) would require member organizations to develop and maintain adequate controls over each of its business activities. The proposed rule would further require that such controls include the establishment of procedures to independently verify and test the supervisory systems and procedures for those business activities. Member organizations would be required to include in the annual report prepared pursuant to Rule 9.8(g) a review of the member organization's efforts in this regard, including a summary of the tests conducted and significant exceptions identified. The Exchange believes proposed Rule 9.8(c)(i) would enhance the quality of member organizations' supervision.<sup>18</sup>

Proposed Rule 9.8(d) would establish requirements for branch office inspections similar to the requirements of NYSE Rule 342.24. Specifically, Rule 9.8(d) would require a member organization to inspect, at least annually, each supervisory branch office and inspect each non-supervisory branch office at least once every three years.<sup>19</sup> The proposed rule would further require that persons who conduct a member

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<sup>17</sup> Paragraph (a)(3)(iv) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rules 9.8(a)(3)(i), (a)(3)(ii) and (a)(3)(iii) will be deemed to have met such requirements.

<sup>18</sup> Proposed Rule 9.8(c)(i) is modeled after NYSE Rule 342.23. Paragraph (c)(ii) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rule 9.8(c)(i) will be deemed to have met such requirements.

<sup>19</sup> Proposed Rules 9.8(d)(1)(i) and (ii) would provide members with two exceptions from the annual branch office inspection requirement: a member may demonstrate to the satisfaction of the Exchange that other arrangements may satisfy the Rule's requirements for a particular branch office, or based upon a member organization's written policies and procedures providing for a systematic risk-based surveillance system, the member organization submits a proposal to the Exchange and receives, in writing, an exemption from this requirement pursuant to Rule 9.8(e).

organization's annual branch office inspection must be independent of the direct supervision or control of the branch office (i.e., not the branch office manager, or any person who directly or indirectly reports to such manager, or any person to whom such manager directly reports). The Exchange believes that requiring branch office inspections be conducted by someone who has no significant financial interest in the success of a branch office should lead to more objective and vigorous inspections.

Under proposed Rule 9.8(e), any member organization seeking an exemption, pursuant to Rule 9.8(d)(1)(ii), from the annual branch office inspection requirement would be required to submit to the Exchange written policies and procedures for systematic risk-based surveillance of its branch offices, as defined in Rule 9.8(e). Proposed Rule 9.8(f) would require that annual branch office inspection programs include, at a minimum, testing and verification of specified internal controls.<sup>20</sup> Paragraph (d)(3) of Rule 9.8 would provide that a member organization that complies with requirements of the NYSE or the NASD that are substantially similar to the requirements in Rules 9.8(d), (e) and (f) will be deemed to have met such requirements.

In conjunction with the proposed changes to Rules 9.8(d), (e) and (f), the Exchange proposes to amend Rule 9.6 to define "branch office" in a way that is substantially similar to the definition of branch office in NYSE Rule 342.10.

Proposed Rule 9.8(g)(4) would require a member organization to designate a Chief Compliance Officer (CCO).<sup>21</sup> Proposed Rule 9.8(g)(5) would require each member organization's chief executive officer (CEO), or equivalent, to certify annually that the

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<sup>20</sup> Proposed Rules 9.8(e) and (f) are modeled after NYSE Rule 342.25 and 342.26.

<sup>21</sup> Rule 3.6A(b) is revised to add Chief Compliance Officer as a new associated person status under Chapter 9 of Exchange Rules.

member organization has in place processes to: (1) establish and maintain policies and procedures reasonably designed to achieve compliance with applicable Exchange rules and federal securities laws and regulations; (2) modify such policies and procedures as business, regulatory, and legislative changes and events dictate; and (3) test the effectiveness of such policies and procedures on a periodic basis, the timing of which is reasonably designed to ensure continuing compliance with Exchange rules and federal securities laws and regulations.

Proposed Rule 9.8(g)(5) would further require that the CEO attest the CEO has conducted one or more meetings with the CCO in the preceding 12 months to discuss the compliance processes in proposed Rule 9.8(g)(5)(i), that the CEO has consulted with the CCO and other officers to the extent necessary to attest to the statements in the certification, and the compliance processes are evidenced in a report, reviewed by the CEO, CCO, and such other officers as the member organization deems necessary to make the certification, that is provided to the member organization's board of directors and audit committee (if such committee exists).<sup>22</sup>

Under proposed Rule 9.8(b)(2), a member, upon a customer's written instructions, may hold mail for a customer who will not be at his or her usual address for no longer than two months if the customer is on vacation or traveling, or three months if the customer is going abroad. This provision would help ensure that members that hold mail for customers who are away from their usual addresses, do so only pursuant to the customer's written instructions and for a specified, relatively short period of time.<sup>23</sup>

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<sup>22</sup> Proposed Rule 9.8(g)(5) is modeled after NASD Rule 3013 and NYSE Rule 342.30(e).

<sup>23</sup> Proposed Rule 9.8(b)(2) is modeled after NASD Rule 3110(i).

Proposed Rule 9.8(b)(3) would require that, before a customer options order is executed, the account name or designation must be placed upon the memorandum for each transaction. In addition, only a qualified ROP may approve any changes in account names or designations. The ROP also must document the essential facts relied upon in approving the changes and maintain the record in a central location. A member would be required to preserve any account designation change documentation for a period of not less than three years, with the documentation preserved for the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4. The Exchange believes the proposed rule would help to protect account name and designation information from possible fraudulent activity.<sup>24</sup>

Rule 9.10(d) allows member organizations to exercise time and price discretion on orders for the purchase or sale of a definite number of options contracts in a specified security. The Exchange proposes to amend Rule 9.10(d) to limit the duration of this discretionary authority to the day it is granted, absent written authorization to the contrary. In addition, the proposed rule would require any exercise of time and price discretion to be reflected on the customer order ticket. The proposed one-day limitation would not apply to time and price discretion exercised for orders effected with or for an institutional account (as defined in the rule) pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis. The Exchange believes that investors will receive greater protection by clarifying the time such discretionary orders remain pending.<sup>25</sup>

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<sup>24</sup> Proposed Rule 9.8(b)(3) is modeled after NASD Rule 3110(j).

<sup>25</sup> Proposed Rule 9.10(d) is modeled after NASD Rule 2510(d)(1).

### Statutory Basis

The proposed rule change would integrate the supervision and compliance functions relating to member organizations' public customer options activities into the overall supervisory structure of a member organization, thereby eliminating any uncertainty over where supervisory responsibility lies. The proposed rule change would also foster the strengthening of members' and member organizations' internal controls and supervisory systems. As such, the proposed rule changes are consistent with and further the objectives of Section 6(b)(5)26 of the Act, in that they are designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and in general, to protect investors and the public interest.

#### **B. Self-Regulatory Organization's Statement on Burden on Competition**

CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of purposes of the Act.

#### **C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others**

No written comments were solicited or received with respect to the proposed rule change.

#### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or

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<sup>26</sup> 15 U.S.C. 78f(b)(5).

(ii) as to which the self-regulatory organization consents, the Commission will (A) by order approve such proposed rule change, or (B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form  
(<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2007-106 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090.

All submissions should refer to File Number SR-CBOE-2007-106. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld

from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 100 F Street, NE, Washington, D.C. 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2007-106 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>27</sup>

Nancy M. Morris  
Secretary

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17 CFR 200.30-3(a)(12).

**Exhibit 5 to SR-CBOE-2007-106**

(Underscoring indicates material to be added and [brackets] indicate material to be deleted.)

**Chicago Board Options Exchange, Inc.  
Rules**

**Chapter III**

**Membership**

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**Qualification and Registration of Certain Associated Persons**

**Rule 3.6A.** (a) No change.

(b) Associated Person Statuses Under Chapter IX. Associated person statuses under Chapter IX (along with the primary Exchange Rule concerning the status) include: (i) Registered Options Principal (Rule 9.2); (ii) Registered Representative (Rule 9.3); and (iii) Chief Compliance Officer (Rule 9.8) [Senior Registered Options Principal (Rule 9.8); and (iv) Compliance Registered Options Principal (Rule 9.8)].

... *Interpretations and Policies:* No change.

**Chapter IX**

**Doing Business with the Public**

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**Registration of Options Principals**

**Rule 9.2.**

No member organization shall be approved to transact options business with the public until those persons associated with it who are designated as Options Principals have been approved by and registered with the Exchange. Persons engaged in the [management of the member organization's business pertaining to option contracts] supervision of options sales practices or a person to whom the designated general partner or executive officer (pursuant to Rule 9.8) or another Registered Options Principal delegates the authority to supervise options sales practices shall be designated as Options Principals. In connection with their registration, Options Principals shall electronically file a Uniform Application for Securities Industry Registration or Transfer (Form U4) with the NASD's Web CRD System, shall successfully complete an examination prescribed by the Exchange for the purpose of demonstrating an adequate knowledge of the options business and of the Rules of the Exchange, and shall further agree in the U4 filing to abide by the Constitution and Rules of the Exchange and the Rules of the Clearing Corporation. Any person required to complete Form U4 shall promptly electronically file any required amendments to Form U4 with the NASD's Web CRD System. Termination of employment or affiliation of any Registered Options Principal in such capacity shall be promptly electronically reported to the

NASD's Web CRD System together with a brief statement of the reason for such termination on Form U5.

... Interpretations and Policies:

.01. Individuals engaged in the supervision of options sales practices and designated as Options Principals are required to qualify as an Options Principal by passing the Registered Options Principals Examination (Series 4) or the Sales Supervision Examination (Series 9/10).

.02 Individuals who are delegated responsibility pursuant to Rule 9.8 for the acceptance of discretionary accounts, for approving exceptions to a member organization's criteria or standards for uncovered options accounts, and for approval of communications, shall be designated as Options Principals and are required to qualify as an Options Principal by passing the Registered Options Principal Examination (Series 4).

**Registration and Termination of Representatives**

**Rule 9.3. (a) – (c) No change.**

... Interpretations and Policies:

.01 A person accepting orders from non-member customers (unless such customer is a broker-dealer registered with the Securities and Exchange Commission) is required to register with the Exchange and to be qualified by passing the General Securities Representatives Examination (Series 7).

**Branch Offices of Member Organizations**

**Rule 9.6. (a) – (b) No change.**

... Interpretations and Policies

.01 Definition of Branch Office. — A "branch office" is any location where one or more associated persons of a member or member organization regularly conduct the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding:

(A) any location that is established solely for customer service and/or back office type functions where no sales activities are conducted and that is not held out to the public as a branch office;

(B) any location that is the associated person's primary residence; provided that: (i) only one associated person, or multiple associated persons, who reside at that location and are members of the same immediate family, conduct business at the location; (ii) the location is not held out to the public as an office and the associated person does not meet with customers at the location; (iii) neither customer funds nor securities are handled at that location; (iv) the associated person is assigned to a designated branch office, and such

branch office is reflected on all business cards, stationery, advertisements and other communications to the public by such associated person; (v) the associated person's correspondence and communications with the public are subject to all supervisory provisions of the Exchange's rules; (vi) electronic communications (e.g., e-mail) are made through the member's or member organization's electronic system; (vii) all orders are entered through the designated branch office or an electronic system established by the member or member organization that is reviewable at the branch office; (viii) written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the member or member organization; and (ix) a list of the locations is maintained by the member or member organization;

(C) any location, other than a primary residence, that is used for securities business for less than 30 business days in any one calendar year, provided the member or member organization complies with the provisions of (ii) through (viii) of paragraph (B) above;

(D) an office of convenience, where the associated person occasionally and exclusively by appointment meets with customers, which is not held out to the public as a branch office (where such location is on bank premises, however, only signage required by the Interagency Statement (Statement on Retail Sales of Nondeposit Investment Products required under Banking Regulations) may be displayed);

(E) any location that is used primarily to engage in non-securities activities and from which the associated person effects no more than 25 securities transactions in any one calendar year; provided that any advertisements or sales literature identifying such location also sets forth the address and telephone number of the location from which the associated person conducting business at the non-branch locations are directly supervised;

(F) the Floor of a registered national securities exchange where a member or member organization conducts a direct access business with public customers; or

(G) a temporary location established in response to the implementation of a business continuity plan.

Notwithstanding the exclusions in subparagraphs .01(A) - (G) above, any location that is responsible for supervising the activities of persons associated with a member or member organization at one or more non-branch locations of such member or member organization is considered to be a branch office.

For purposes of this Rule, the term "business day" shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

For purposes of this Rule, the term "associated person of a member or member organization" is defined as a member or employee associated with a member or member organization.

For purposes of .01(B)(viii) above, written supervisory procedures shall include criteria for on-site for cause reviews of an associated person's primary residence. Such reviews must utilize risk-based sampling or other techniques designed to assure compliance with applicable securities laws and regulations and with Exchange Rules.

For purposes of .01(B)(viii) and (C) above, written supervisory procedures for such residences and other remote locations must be designed to assure compliance with applicable securities laws and regulations and with Exchange Rules.

Factors which should be considered when developing risk-based sampling techniques to determine the appropriateness of on-site for cause reviews of selected residences and other remote locations shall include, but not be limited to, the following: (i) the firm's size; (ii) the firm's organizational structure; (iii) the scope of business activities; (iv) the number and location of offices; (v) the number of associated persons assigned to a location; (vi) the nature and complexity of products and services offered; (vii) the volume of business done; (viii) whether the location has a Series 9/10-qualified person on-site; (ix) the disciplinary history of the registered persons or associated persons, including a review of such person's customer complaints and Forms U4 and U5; and (x) the nature and extent of a registered person's or associated person's outside business activities, whether or not related to the securities business.

### **Opening of Accounts**

**Rule 9.7 (a)-(e)** No change.

(f) Every member organization transacting business with the public in uncovered option contracts shall develop, implement and maintain specific written procedures governing the conduct of such business which shall include, at least, the following:

1. Specific criteria and standards to be used in evaluating the suitability of a customer for uncovered short option transactions;
2. Specific procedures for approval of accounts engaged in writing uncovered short option contracts, including written approval of such accounts by a Registered Options Principal;
3. Designation of [the Senior Registered Options Principal and/or Compliance Registered Options Principal] a specific Registered Options Principal qualified individual(s) as the person(s) responsible for approving accounts which do not meet the specific criteria and standards for writing uncovered short option transactions and for maintaining written records of the reasons for every account so approved;
4. Establishment of specific minimum net equity requirements for initial approval and maintenance of customer uncovered option accounts; and
5. Requirements that customers approved for writing uncovered short options transactions be provided with a special written description of the risks inherent in writing uncovered short option transactions, at or prior to the initial uncovered short option transaction. See Rule 9.15(c).

*...Interpretations and Policies:* No Change.

### **Supervision of Accounts**

**Rule 9.8 (a) *Duty to Supervise***[; *Senior Registered Options Principal*]. The general partners or directors of [Every] each member organization that conducts a non-member customer business shall [develop and implement a written program for the review of the organization's non-member

customer accounts and all orders in such accounts, insofar as such accounts and orders relate to option contracts.] provide for appropriate supervisory control and shall designate a general partner or executive officer, who shall be identified to the Exchange, to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities laws and regulations. This person, who may be the same individual designated pursuant to substantially similar New York Stock Exchange or National Association of Securities Dealers rules, shall:

1. Delegate to qualified employees responsibilities and authority for supervision and control of each office, department or business activity, and shall provide for appropriate written procedures of supervision and control.
2. Establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.
3. Develop and implement written policies and procedures reasonably designed to independently supervise the activities of accounts serviced by branch office managers, sales managers, regional/district sales managers or any person performing a similar supervisory function. Such supervisory reviews must be performed by a qualified Registered Options Principal who:

- i. Is either senior to, or otherwise independent of, the producing manager under review. For purposes of this Rule, an "otherwise independent" person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less. Further, if a person designated to review a producing manager receives an override or other income derived from that producing manager's customer activity that represents more than 10% of the designated person's gross income derived from the member organization over the course of a rolling twelve-month period, the member organization must establish alternative senior or otherwise independent supervision of that producing manager to be conducted by a qualified Registered Options Principal other than the designated person receiving the income.
- ii. If a member organization is so limited in size and resources that there is no qualified Registered Options Principal senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to paragraph (a)(3)(i) of this Rule (for instance, the member organization has only one office, or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a Registered Options Principal in compliance with paragraph (a)(3)(i) of this Rule to the extent practicable.
- iii. A member organization relying on paragraph (a)(3)(ii) of this Rule must document the factors used to determine that complete compliance with all of the provisions of paragraph (a)(3)(i) of this Rule is not possible, and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of paragraph (a)(3)(i) of this Rule to the extent practicable.

- iv. A member organization that complies with requirements of the New York Stock Exchange or the National Association of Securities Dealers that are substantially similar to the requirements in paragraphs (a)(3)(i), (a)(3)(ii) and (a)(3)(iii) of this Rule will be deemed to have met such requirements.

[This program shall be under the supervision of a designated Senior Registered Options Principal who is specifically identified to the Exchange and who is an officer (in the case of a corporation) or general partner (in the case of a partnership) of the member organization. Every member organization shall also develop and implement specific written procedures concerning the manner of supervision of customer accounts maintaining uncovered short (written) option positions and specifically providing for frequent supervisory review of such accounts.]

[(b) *Compliance Registered Options Principal.* Every member organization shall designate and specifically identify to the Exchange a Compliance Registered Options Principal (who may be the Senior Registered Options Principal), who shall have no sales functions and shall be responsible to review and to propose appropriate action to secure the member organization's compliance with securities laws and regulations and Exchange rules in respect of its options business. The Compliance Registered Options Principal shall regularly furnish reports directly to the compliance officer (if the Compliance Registered Options Principal is not himself the compliance officer) and to other senior management of the member organization. The requirement that the Compliance Registered Options Principal shall have no sales functions does not apply to a member organization that has received less than \$1,000,000 in gross commissions on options business as reflected in its FOCUS Report for either of the preceding two fiscal years or that currently has 10 or fewer Registered Representatives.]

(b) [(c)] Maintenance of Customer Records.

1. Background and financial information of customers who have been approved for options transactions shall be maintained at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction over that branch office. Copies of account statements of options customers shall be maintained at both the branch office supervising the accounts and the principal supervisory office having jurisdiction over that branch for the most recent six-month period. With respect to the record retention responsibility of principal supervisory offices, customer information and account statements may be maintained at a location off premises so long as the records are readily accessible and promptly retrievable. Other records necessary to the proper supervision of accounts shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office.
2. Upon the written instructions of a customer, a member may hold mail for a customer who will not be at his or her usual address for the period of his or her absence, but (A) not to exceed two months if the member is advised that such customer will be on vacation or traveling or (b) not to exceed three months if the customer is going abroad.
3. Before any customer order is executed, there must be placed upon the memorandum for each transaction, the name or designation of the account (or accounts) for which such order is to be executed. No change in such account name(s) (including related accounts) or designation(s) (including error accounts) shall be made unless the change has been authorized by a member or a person(s) designated by the designated general partner or executive officer (pursuant to Rule 9.8). Such person must, prior to giving his or her

approval of the account designation change, be personally informed of the essential facts relative thereto and indicate his or her approval of such change in writing on the order or other similar record of the member. The essential facts relied upon by the person approving the change must be documented in writing and preserved for a period of not less than three years, the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4.

For purposes of this paragraph (b)(3), a person(s) designated by the designated general partner or executive officer (pursuant to Rule 9.8) must be a Registered Options Principal.

(c) *Internal Controls.* (i) Member organizations must develop and maintain adequate controls over each of its business activities. Such controls must provide for the establishment of procedures for verification and testing of those business activities. An ongoing analysis, based upon appropriate criteria, may be employed to assess and prioritize those business activities requiring independent verification and testing. A review of each member organization's efforts with respect to internal controls, including a summary of tests conducted and significant exceptions identified, must be included in the annual report required by paragraph (g) of this Rule.

(ii) A member organization that complies with requirements of the New York Stock Exchange or the National Association of Securities Dealers that are substantially similar to the requirements in paragraph (c)(i) of this Rule will be deemed to have met such requirements.

(d) *Annual Branch Office Inspections.*

1. Each branch office that supervises one or more non-branch locations must be inspected no less often than once each calendar year unless:
  - (i) it has been demonstrated to the satisfaction of the Exchange that because of proximity, special reporting or supervisory practice, other arrangements may satisfy this Rule's requirements for a particular branch office; or
  - (ii) based upon the written policies and procedures of such member organization providing for a systematic risk-based surveillance system, the member organization submits a proposal to the Exchange and receives, in writing, an exemption from this requirement pursuant to paragraph (e) of this Rule.
2. Every branch office, without exception, must be inspected at least once every three calendar-years. All required inspections must be conducted by a person who is independent of the direct supervision and control of the branch office in question (i.e., not the branch office manager, or any person who directly or indirectly reports to such manager, or any person to whom such manager directly reports). Written reports reflecting the results of such inspections are to be maintained at the member organization for the longer of three years or until the next branch office inspection.
3. A member organization that complies with requirements of the New York Stock Exchange or the National Association of Securities Dealers that are substantially similar to the requirements in paragraph (d)(1) and (d)(2) of this Rule as well as to related requirements in paragraphs (e) and (f) of this Rule will be deemed to have met such requirements.

(e) Risk-Based Surveillance and Branch Office Identification.

1. Any member organization seeking an exemption, pursuant to Rule 9.8(d)(1)(ii), from the annual branch office inspection requirement must submit to the Exchange written policies and procedures for systematic risk-based surveillance of its branch offices. Such policies and procedures should reflect, among other factors, the member organization's business model and product mix. Such policies and procedures must also, at a minimum, provide for:
  - (i) The inspection of branches where developments during the year require a reconsideration of such branch's exemption;
  - (ii) A requirement that no less than half of the branch offices inspected each year on a cycle basis be done on an unannounced basis; and
  - (iii) A system to enable employees to report compliance issues on a confidential basis outside of the branch office chain of command.
2. For purposes of paragraph (e)(1) of this Rule, the risk-based factors to be considered should include, but not necessarily be limited to, the following:
  - (i) Number of Registered Representatives;
  - (ii) A significant increase in the number of Registered Representatives;
  - (iii) Number of customers and volume of transactions;
  - (iv) A significant increase in branch office revenues;
  - (v) Incidence of concentrated securities positions in customer's accounts;
  - (vi) Aggregate customer assets held;
  - (vii) Nature of the business conducted and the sales practice risk to investors associated with the products sold, and product mix (e.g. options, equities, mutual funds, annuities, etc.);
  - (viii) Numbers of accounts serviced on a discretionary basis;
  - (ix) Compliance and regulatory history of the branch, including:
    - (A) Registered Representatives subject to special supervision by the member organization, self-regulatory authorities, state regulatory authorities or the Securities and Exchange Commission in years other than the previous or current year;
    - (B) Complaints, arbitrations, internal discipline, or prior inspection findings; and
    - (C) Persons subject to recent disciplinary actions by self-regulatory authorities, state regulatory authorities or the Securities and Exchange Commission.
  - (x) Operational factors, such as the number of errors and account designation changes per Registered Representative;
  - (xi) Incidence of accommodation mailing addresses (e.g., post office boxes and "care of" accounts);
  - (xii) Whether the branch office permits checks to be picked up by customers or hand delivery of checks to customers;

- (xiii) Experience, function (producing or non-producing) and compensation structure of branch office manager;
  - (xiv) Branch offices recently opened or acquired; and
  - (xv) Changes in branch location, status or management personnel.
3. Notwithstanding any policies or procedures implemented pursuant to this Rule, branch offices that meet any of the following criteria must be inspected no less often than once each calendar year:
- (i) Offices with one or more Registered Representatives subject to special supervision as required by a self-regulatory authority or state regulatory authority during the current or immediately preceding year.
  - (ii) Offices with 25 or more registered individuals;
  - (iii) Offices in the top 20% of production or customer assets for the member organization;
  - (iv) Any branch office not inspected within the previous two calendar years; and
  - (v) Any branch office designated as exercising supervision over another branch office.
- (f) Criteria for Inspection Programs. An annual branch office inspection program must include, but is not limited to, testing and independent verification of internal controls related to the following areas:
- 1. Safeguarding of customer funds and securities;
  - 2. Maintaining books and records;
  - 3. Supervision of customer accounts serviced by branch office managers;
  - 4. Transmittal of funds between customers and Registered Representatives and between customers and third parties;
  - 5. Validation of customer address changes; and
  - 6. Validation of changes in customer account information.
- (g) Written Report. By April 1 of each year, each member organization that conducts a non-member customer business shall submit to the Exchange a written report on the member organization's supervision and compliance effort during the preceding year and on the adequacy of the member organization's ongoing compliance processes and procedures. Each member organization that conducts a public customer options business shall also specifically include its options compliance program in the report. The report shall include, but not be limited to, the following:
- 1. A tabulation of customer complaints (including arbitrations and civil actions) and internal investigations.
  - 2. Identification and analysis of significant compliance problems, plans for future systems or procedures to prevent and detect violations and problems, and an assessment of the proceeding year's efforts of this nature.
  - 3. Discussion of the preceding year's compliance efforts, new procedures, educational programs, etc. in each of the following areas: (i) antifraud and trading practices; (ii) investment banking activities; (iii) sales practices; (iv) books and records; (v) finance and operations; (vi) supervision; (vii) internal controls, and (viii) anti-money laundering. If any of these areas do not apply to the member organization, the report shall so state.

4. For each member organization, the designation of a general partner or principal executive officer as Chief Compliance Officer (which designation shall be updated on Schedule A of Form BD).
5. A certification signed by the member organization's Chief Executive Officer (or equivalent), that:

i. The member organization has in place processes to:

- (A) establish and maintain policies and procedures reasonably designed to achieve compliance with applicable Exchange Rules and federal securities laws and regulations,
- (B) modify such policies and procedures as business, regulatory and legislative changes and events dictate, and
- (C) test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with Exchange Rules and federal securities laws and regulations.

(ii) In member organizations, the Chief Executive Officer (or equivalent officer) conducted one or more meetings with the organization's Chief Compliance Officer during the preceding 12 months, and that they discussed and reviewed the matters described in this certification, including the organization's prior compliance efforts, and identified and addressed significant compliance problems and plans for emerging business areas.

(iii) In member organizations, the processes described in paragraph (g)(5)(i) of this Rule, are evidenced in a report reviewed by the Chief Executive Officer (or equivalent officer), Chief Compliance Officer and such other officers as the organization may deem necessary to make this certification, and submitted to the organization's board of directors and audit committee (if such committee exists) on or before April 1<sup>st</sup> of each year.

(iv) In member organizations, the Chief Executive Officer (or equivalent officer) has consulted with the Chief Compliance Officer and other officers referenced in paragraph (g)(5)(iii) of this Rule and such other employees, outside consultants, lawyers and accountants, to the extent they deem appropriate, in order to attest to the statements made in this certification.

A member organization that specifically includes its options compliance program in a report that complies with substantially similar requirements of the New York Stock Exchange or the National Association of Securities Dealers will be deemed to have met the requirements of this Rule 9.8(g) and Rule 9.8(h).

(h) Reports to Control Persons. By April 1 of each year, each member organization shall submit a copy of the report that Rule 9.8(g) requires the member organization to prepare to its one or more control persons or, if the member organization has no control person, to the audit committee of its board of directors or its equivalent committee or group. In the case of a control person that is an organization (a "controlling organization"), the member organization shall submit the report to the general counsel of the controlling organization and to the audit committee of the controlling organization's board of directors or its equivalent committee or group. For the

purpose of this paragraph, "control person" means a person who controls the member organization within the meaning of Rule 1.1(k).

*... Interpretations and Policies:*

**.01** [The Senior Registered Options Principal, in meeting his responsibility for supervision of non-member customers' accounts and orders, may delegate to qualified employees responsibility and authority for supervision and control of each branch office handling options transactions, provided that the Senior Registered Options Principal shall have overall authority and responsibility for establishing appropriate procedures of supervision and control over such employee.]

**[.02** Every] each member organization that conducts a non-member customer business shall establish, maintain, and enforce written procedures which detail the specific methods used to supervise all non-member customer accounts, and all orders in such accounts [, insofar as such accounts and orders relate to option contracts]. Such written procedures shall specifically identify the titles and positions of individuals who have been delegated authority and responsibility for an identified segment of the member organization's business, including option compliance functions. The procedures shall also include the registration status and location of all such supervisory and compliance personnel. Each member organization shall also develop and implement specific written procedures concerning the manner of supervision of customer accounts maintaining uncovered short option positions, and specifically providing for frequent supervisory review of such accounts.

**.02 [.03]** Each member organization shall maintain at the principal supervisory office having jurisdiction over the office servicing the customer's account, or shall have readily accessible and promptly retrievable, information to permit review of each customer's options account on a timely basis to determine (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; (ii) the size and frequency of options transactions; (iii) commission activity in the account; (iv) profit or loss in the account; (v) undue concentration in any options class or classes and (vi) compliance with the provisions of Regulation T of the Federal Reserve Board.

**.03** Documentation evidencing the annual written report required by paragraph (g) of this rule, must be maintained in a place that is easily accessible and shall be provided to the Exchange upon request.

### **Discretionary Accounts**

**Rule 9.10. (a) Authorization and Approval Required.** No member organization shall exercise any discretionary power with respect to trading in options contracts in a customer's account unless such customer has given prior written authorization and the account has been accepted in writing by a Registered Options Principal. [The Senior Registered Options Principal] Each firm shall designate specific Registered Options Principal qualified individuals pursuant to Rule 9.8 to review discretionary accounts. A Registered Options Principal qualified person specifically delegated such responsibilities under Rule 9.8 (who is an individual other than the Registered Options Principal who accepted the account) shall review the acceptance of each discretionary account to determine that the Registered Options Principal accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the strategies or transactions proposed, and he shall maintain a record of the basis for his determination. [Each

discretionary order shall be approved and initialed on the day entered by the branch office manager or other Registered Options Principal, provided that if the branch office manager is not a Registered Options Principal, his approval shall be confirmed within a reasonable time by a Registered Options Principal.] Every discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review by [the Compliance Registered Options Principal] a Registered Options Principal qualified person specifically delegated such responsibilities under Rule 9.8, who is not exercising the discretionary authority.

(b) No change.

(c) No change.

(d) *Discretion as to Price or Time Excepted.* This rule shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of option contracts in a specified security shall be executed, except that the authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer. This limitation shall not apply to time and price discretion exercised in an institutional account, as defined below, pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis. Any exercise of time and price discretion must be reflected on the order ticket. As used in this paragraph (d) the term "institutional account" shall mean the account of: (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (iii) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

(e) No change.

...Interpretations and Policies:

.01 Any member organization that does not utilize computerized surveillance tools for the frequent and appropriate review of discretionary account activity must establish and implement procedures to require Registered Options Principal qualified individuals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered.

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## Chapter XXVI

### Market Baskets

#### Doing Business with the Public

**Rule 26.10 (a) *Applicability of Rules.*** The provisions of Chapter IX of the Rules shall be applicable to market baskets except as set forth herein. Rule 9.2 (relating to the registration of options principals), Rule 9.7 (relating to the opening of customer accounts), Rules 9.15 and 9.21(d) (relating to the options disclosure document), Rule 9.9 (relating to the suitability of recommendations), Rule 9.11 (relating to the confirmation of transactions), and Rule 9.21 (relating to communications to customers) shall not be applicable to market basket contracts. Whenever Chapter IX of the Rules requires a particular function to be performed by a Registered Options Principal, [(including a Senior Registered Options Principal or Compliance Registered Options Principal),] that function may be performed in respect of market baskets by a principal of the member organization (including a branch office manager thereof) that is registered as such with a national securities exchange or a registered securities association.

(b) - (d) No Change.

...*Interpretations and Policies:* No change.