

Regulatory Circular RG98-48

Date: February 3, 1998

To: Modified Trading System Appointments Committee

From: Board of Directors

Re: Guidelines Pertaining to Transfers of Interests in DPM Appointments Under New Rule 8.89

The Board of Directors today authorized a series of rules pertaining to the operation and oversight of Designated Primary Market Makers ("DPMs") to be filed with the SEC for approval. Among the twelve rules which constitute the series of rules to be filed is proposed Rule 8.89, which will clarify CBOE's existing rules and practices pertaining to the transfer of interests in DPM appointments. New Rule 8.89 is not intended to change the long-standing policy that does not generally view a DPM's appointment as constituting a transferable property interest owned by the DPM. The proposed Rule will continue to require the approval of the Modified Trading System ("MTS") Appointments Committee ("Committee") for any transaction that involves the transfer of any significant interest in a DPM, and it will continue to vest broad discretion in the Committee to decide whether or not to approve any such transactions. The proposed Rule describes in greater detail the kinds of transactions that may be deemed to involve the transfer of a DPM appointment requiring Committee approval, it establishes procedures to be followed in connection with a proposal to transfer an interest in a DPM appointment, it lists the factors to be taken into account by the Committee in deciding whether to approve a particular transfer, and it makes it clear that any decision by the Committee to approve or disapprove a transfer is subject to review by the full Board of Directors.

The purpose of this memorandum is to convey to the Committee and to the CBOE membership the sense of the Board of Directors concerning the various factors that may bear upon a decision whether a particular transfer of an interest in a DPM appointment should be approved. In this regard, the Board believes the starting point is the basic principal that a DPM's franchise in his appointed classes is not a transferable property interest owned by the DPM. Nevertheless, the Board recognizes that there are circumstances where it may be in the best interests of both the DPM and the Exchange to permit the transfer of some or all of the DPM's interest in his appointment, even though this may result in the DPM being paid for the value of the goodwill in his DPM business. Examples of such circumstances might be where a transfer is for the purpose of attracting new capital to an existing successful DPM to enable it to expand its market-making activities, or to enable the DPM to bring in a new partner or other principal, or in response to an emergency need for capital where there is reason to permit the existing DPM to remain involved in the operation and therefore not to reallocate his appointment, assuming in each case that the expansion, addition to or increase in capital is found to be necessary or desirable in the best interests of the Exchange. In most of these cases, the transfer would be for less than 100% of the ownership of the DPM enterprise, and the existing DPM would remain significantly involved in the operation for some reasonable period of time after the transfer. It is not contemplated that even transfers or changes in ownership or structure of a DPM such as these would be automatically

approved, nor is there any particular set of facts or any other formula that may be used to predict when a transfer should be approved. Instead, each situation should be judged on its merits, not only in light of whether the transfer or other changes to the structure or ownership of the DPM will improve the performance of the DPM, but also whether the transaction is necessary, desirable and in the best interests of the CBOE.

On the other hand, the Board of Directors does not believe that the outright sale of all or a part of a DPM's business should ordinarily be approved. Thus a DPM should not ordinarily be permitted to place some or all of the DPM operation up for sale to the highest qualified bidder. If such a proposal is made under circumstances where it is clear that the original DPM is either unwilling, unable or unqualified to remain active in the business after the transfer, the response of the Committee would ordinarily be expected to be to reallocate the DPM's appointment to one or more other qualified applicants (which could include the person to whom the DPM proposed to transfer his appointment), but without any payment being made to the DPM. Because there is often not a sharp line between a proposal to sell a DPM operation outright, and a proposal to transfer an interest in a DPM where the existing DPM continues to remain involved in ownership, control or management of the operation, the new Rule gives broad discretion to the Committee to approve or disapprove these kinds of transactions, based on its consideration of a number of stated factors. One important factor which, while not the only factor, is one that the Committee is encouraged to consider, is whether there will be continuity of ownership, control, management and operation of a DPM after the transfer. However, the Board does not believe this single factor should be given overriding emphasis by the Committee, especially if the existing DPM's performance is deemed to have been substandard.

In general, in considering any proposed transfer of an interest in a DPM appointment, the Committee should consider the best interests of the Exchange and its members, as well as what if any alternatives to the transfer are available. This will necessarily vary from case to case, but could include such alternatives as approving a totally different proposal, which might be one that came forward in response to the posting of the original proposal pursuant to the requirements set forth in the new Rule, or not approving any transfer but instead reallocating the DPM's appointed classes either to one or more other DPMs, or to one or more competing market maker crowds.

Although the new DPM rule package is not expected to be approved by the SEC for some time, the Board of Directors expects the MTS Committee to immediately begin adhering to the guidelines set forth in this memorandum and to process all future DPM transfer requests in accordance with the administrative process set forth in the proposed Rule 8.89.