

Regulatory Circular 99-123

**Date:** May 17, 1999

**To:** Members and Member Organizations

**From:** Department of Financial and Sales Practice Compliance

**Re:** Borrowing of Trading Capital

**Exchange** Robert Gardner (312) 786-7937

**Contacts:** Peter Dorenbos (312) 786-7414

**The purpose of this circular is to address recent changes in Federal Reserve Board requirements for loans to market-makers, and to respond to numerous member inquiries regarding market-maker reporting requirements related to borrowing capital for trading purposes. Members are encouraged to review this circular carefully because rule violations in this area may be presented to the Business Conduct Committee (BCC) and result in disciplinary action.**

#### **KEY ISSUES**

- All market-maker financial arrangements must be reported to the Department of Financial and Sales Practice Compliance on the prescribed form.
- Non-member, non-bank lenders must attest to having received certain disclosures and to an understanding of the risks in the lending arrangement.
- Clearing firm unsecured loans to market-maker customers for market-maker trading are no longer prohibited and need not be subordinated, even if used to remedy a deficit equity.
- Loans structured to provide for profit and/or loss participants are not acceptable as loans under Exchange rules. Such arrangements must be codified in a joint account or other formal legal structure (e.g. partnership) and be disclosed to the Exchange and receive formal approval where required.

#### **DISCUSSION:**

##### **FORM 8.10**

Market-makers are permitted to borrow capital from members or non-members. However, Exchange Rule 8.10 requires that the terms of such financing arrangements be disclosed to the Exchange. This disclosure can be made by completing Form 8.10 which is available in the

Department of Financial and Sales Practice Compliance. Unless the lender is a financial institution, or has a close affiliation with the borrower such as officer or general partner, the lender will be required to complete an attestation that he has received certain disclosures and undertaken appropriate measures to evaluate the risks of entering into the loan. Additionally, the lender must acknowledge in the agreement that all the trading decisions are being made by the borrower. Subordinated loans are still required where the loan is to be used to increase the regulatory capital of a member subject to SEC Rule 15c3-1 (net capital rule).

### **CLEARING FIRM LOANS**

Broker-dealers that finance and clear the transactions of broker-dealers who are market-makers, are no longer prohibited from making loans to their market-maker customers for purposes of financing a market-maker account provided the financing is made solely to permit market-making activities. It should be noted that loans made by clearing firms to a market maker customer whose account is in deficit are not required to be made on a subordinated basis. However, the Exchange requires notification of such financial arrangements according to Exchange Rule 8.10. Finally, the loan must be made to the market-maker and the proceeds must be deposited in the account. The account cannot be carried in a deficit with the understanding that it is guaranteed by the clearing firm. The loan receivable is a non-allowable asset for the clearing firm.

### **LOAN CHARACTERISTICS**

Loans used by members to finance trading must have the characteristics generally associated with a loan - fixed maturity date, interest rate, regular payments, etc. Loans which include the sharing of profits and losses, or which forfeit the repayment of principal if there are no profits, will be deemed a partnership arrangement and therefore will not be approved as loans. Members who wish to enter into a profit/loss sharing arrangement with other members may do so through a joint account or an Exchange approved partnership or corporation.

After completing either the subordinated loan form or the Form 8.10, the document must be submitted to the Department of Financial and Sales Practice Compliance for its approval. Once the document has been approved, the trading capital may then be deposited in the member's (borrower's) trading account.

### **CONTACTS**

Questions relating to this circular should be addressed to either Robert Gardner at (312) 786-7937 or Peter Dorenbos at (312) 786-7414 in the Department of Financial and Sales Practice Compliance.