



REGULATORY CIRCULAR RG05-102

TO: Members and Member Firms - Compliance Departments
FROM: Regulatory Services Division/Legal Division
RE: Compliance with Section 11(a) of the Securities Exchange Act of 1934 and the Rules Thereunder
DATE: November 2, 2005

This circular provides members with information on compliance with Section 11(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") which concerns proprietary trading on the Exchange by Exchange members. While Section 11(a)(1) has not changed since the Exchange previously issued Regulatory Circular RG94-11 (Feb. 1, 1994) explaining the operation and application of Section 11(a)(1), this circular updates and supplements the information provided in RG94-11.

As an initial matter, please note that Market-Makers effecting transactions in a market-making capacity are generally exempt from the restrictions of Section 11(a)(1). Further, members that submit proprietary orders from off the floor and obtain executions through an unaffiliated executing broker may also qualify for an exemption known as the "Effect vs. Execute" Rule (described in greater detail below). Accordingly, this circular may be of primary interest to member firms that submit proprietary orders to CBOE for execution through an affiliated broker.

Section 11(a)(1) Generally

Section 11(a)(1) of the Exchange Act restricts securities transactions of a member of any national securities exchange effected on that exchange for (i) the member's own account, (ii) the account of a person associated with the member, or (iii) an account over which the member or a person associated with the member exercises discretion (collectively, "covered accounts") unless a specific exemption is available, such as transactions by broker dealers acting in the capacity of a market maker and other exemptions described below.

Statutory Exemptions from Section 11(a)(1)

As mentioned above, there are several exemptions to Section 11(a)(1). These include transactions by a dealer acting in the capacity of a market maker (such as a DPM, e-DPM, RMM, LMM or Market-Maker on CBOE), any bona fide hedge transaction, or any bona fide arbitrage

transaction.¹ The SEC may also establish rules that provide exemptive relief from the restrictions of Section 11(a)(1). Thus, while CBOE Market-Maker transactions generally qualify for an exemption from Section 11(a)(1), non-Market-Maker members must qualify pursuant to one of the other exemptions.

“(G) Order” Exemption

Section 11(a)(1)(G) exempts from the prohibitions of Section 11(a) transactions effected for a member’s own account if the member obtains more than 50% of its gross revenue from eligible sources identified in the subparagraph (which generally includes underwriting, selling securities to customers, and acting as a broker), the member discloses to any member to whom the order is transmitted that the order is a proprietary order (a so-called “G” order), and the member clearly discloses to the trading crowd that the order is a G order.² *A G order must yield to any non-member order.*

Members intending to rely on the “G” exemption must file with the Exchange financial information indicating that more than 50% of their gross revenue for the prior year was received from eligible sources, as set forth above, and must mark each order to be effected in reliance on the exemption as a “G order.”

Rule 11a2-2(T): The “Effect vs. Execute” Exemptive Rule

The SEC also has adopted rules that provide an exemption in certain situations from the Section 11(a) prohibitions. One of the most frequently-used exemptions, Rule 11a2-2(T), the so-called “effect vs. execute” rule, enables members to effect transactions for covered accounts by using another member, acting as broker, to execute the transaction on the Exchange (or through the use of the Exchange’s facilities), provided that:

- i. the executing broker is not an associated person of the initiating member;
- ii. the covered account order must be transmitted from off the exchange floor;
- iii. neither the initiating member nor any associated person of the initiating member participates in execution of the order after the covered account order has been transmitted for execution from off the floor (referred to below as the “non-participation requirement”); and

¹ The SEC has provided very specific guidance as to the meaning of bona fide hedge and bona fide arbitrage. Members may wish to consult Securities Exchange Act Release No. 15533 (Jan. 29, 1979) for further guidance as to SEC interpretations of bona fide hedge and bona fide arbitrage.

² For a further explanation of (G) orders generally, *see* Regulatory Circular RG94-11.

- iv. if the transaction is being effected for an account over which the initiating member or an associated person of that member exercises investment discretion, neither the initiating member nor any associated person may retain any compensation in connection with effecting the transaction unless express written consent to such retention has been obtained from the person or persons authorized to transact business for the managed account in the manner provided in the rule.

Thus, a member (not acting in a market-making capacity) could submit an order from off the floor *to an unaffiliated broker* for representation on the floor and use the effect versus execute exemption (assuming the other conditions of the rule are satisfied). In contrast, if the member submitted the order to its “house” broker on the trading floor, the restrictions of Section 11a would apply and a different exemption would be necessary.

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Members seeking further information as to the application of Section 11(a) or any of the exemptions from the prohibitions of that section should contact Angelo Evangelou, Legal Division, at (312) 786-7464.