CBOE
CHICAGO BOARD OPTIONS EXCHANGE

400 S. La Salle
Chicago, IL 60605

Regulatory Circular RG09-86

To: Members

From: Trading Operations &
Member and Regulatory Services

Date: August 18, 2009

Re: Tied Hedge Transactions

CBOE is pleased to announce that the SEC has approved a rule change, SR-CBOE-2009-007, which adopts a limited exception to the anticipatory hedging rule for "tied hedge" transactions executed in open outcry.[1] The Exchange has determined to make the tied hedge procedures available for all options classes, including FLEX options.

Under the procedures, a member or member organization may buy or sell a stock, security futures or futures position following receipt of an option order and prior to announcing the option order to the trading crowd, subject to the requirements outlined below:

- Minimum Size: The option order may be a simple order or a complex order (*e.g.*, spread, straddle, combination, stock-option order, etc.). To be eligible, the order must be for at least 500 contracts.[2] This is a per-order requirement. Multiple orders cannot be aggregated to satisfy this size parameter. In the case of a complex order, at least one leg alone must be for at least 500 contracts.

- Electronic Record: The member or member organization must create an electronic record that it is engaging in a tied hedge transaction that is in a form and manner prescribed by CBOE. To accommodate this requirement for trades involving non-FLEX options, CBOE a checkbox is available within the Floor Broker Workstation (FBW) order ticket. Any questions about the FBW checkbox should be directed to Monica Wiedlin-Torres, Trading Operations, at 312-786-7368. For trades involving FLEX options, members and member organizations need to contact the FLEX Desk in the CBOE Help Desk or call 312-460-1941 to log the

[1] CBOE's anticipatory hedging rule provides that it will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 for any member or person associated with a member, who has knowledge of all material terms and conditions of an original order and a solicited order, including a facilitation order, that matches the original order's limit, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option of the same class as an option that is the subject of the original order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (i) all the terms and conditions of the original order and any changes in the terms and conditions of the original order of which that member or associated person has knowledge are disclosed to the trading crowd or (ii) the solicited trade can no longer reasonably be considered imminent in view of the passage of time since the solicitation. *See* Rule 6.9(e).

[2] A FLEX Index Option also has to meet certain minimum value size requirements. *See* Rules 24A.4 and 24B.4.

information into the Market Activity Database (MAD). Requests to use a system other than FBW or MAD to satisfy this requirement should be directed to Tim MacDonald, Member & Regulatory Services, at 312-786-7706.

- Eligible Hedge: The hedge position must be in the stock underlying the option order, in a security future overlying the stock applicable to the option order or, in the case of an index, ETF or HOLDRS option, in a related instrument.[3] A hedge position in another option series is not permitted under the tied hedge procedures. In addition, the hedge position cannot exceed the option order on a delta basis.[4]

- Trading Procedures: Once a hedge position is obtained following receipt of an eligible option order, the following trading procedures apply:

    - The hedge position must be brought without undue delay to the trading crowd and announced in open outcry concurrently with the option order, offered to the trading crowd in its entirety, and offered at the execution price received by the member or member organization introducing the option to any in-crowd market participant (ICMP) who has established parity or priority for the related options.

    - ICMPs that participate in the option transaction must also participate in the hedging position and may not prevent the option transaction from occurring by giving a competing bid or offer for one component of the tied hedge package.

    - All tied hedge transactions (regardless of whether the option order is a simple or complex order) are treated the same as complex order transactions for purposes of CBOE's intra-market allocation and reporting procedures for open outcry trading. For example, a tied hedge order is presented at a net price, may be expressed in any increment (except that SPX, OEX and XEO tied hedge package other than box/roll spreads must be in decimal increments no smaller than $0.05), and the legs may be executed in $0.01 increments. A tied hedge transaction is also subject to the special priority procedures for complex orders executed in open outcry under Rules 6.45A(b)(ii) and 6.45B(b)(ii).

    - All tied hedge transactions are subject to NBBO trade-through restrictions for options and stock, as applicable, and may qualify for various exceptions.[5] Please note, however, in the scenario where the option order is a simple order: (i) the execution of the stock hedge following receipt of the simple order but prior to announcement of the tied hedge package to the trading crowd would not qualify for the Regulation NMS Qualified Contingent Trade (QCT) NBBO trade-through exemption; (ii) the execution of the option leg of the tied hedge package would not qualify for the

---

[3] For an index option, a "related instrument" means securities comprising ten percent or more of the component securities in the index or a futures contract on any economically equivalent index applicable to the option order. With respect to SPX, OEX is an economically equivalent index, and vice versa. For an ETF or HOLDRS option, a "related instrument" means a futures contract on any economically equivalent index applicable to the ETF or HOLDR underlying the option order.

[4] In the scenario where the introducing member purchases (sells) less than the delta, *e.g.*, when there is not enough stock is available to buy (sell) at the desired price, the introducing member would present the stock that was purchased (sold) and share it with the in-crowd market participants on equal terms.

[5] For a list of NBBO trade-through exceptions for options, please refer to CBOE Rule 6.83. For a list of NBBO trade-through exceptions for stocks, please refer to Rule 611 of Regulation NMS.

Options Linkage's NBBO trade-through exception for a Complex Trade (defined in Rule 6.80(4)); and (iii) the execution of the stock leg where the trading crowd participates may qualify for the Regulation NMS QCT NBBO trade-through exemption. In the scenario where the option order is a complex order, the executions may qualify for the CQT and Complex Trade NBBO trade-through exceptions (just the same as with any other complex order).

- Please be aware that, at the time a tied hedge package is presented for execution in a trading crowd, market conditions in the options or stock, security futures or futures may prevent the execution from occurring. For example, the execution price of the stock leg of a tied hedge package may be outside the BBO of the specific market(s) where the stock was to be filled (*e.g.*, the stock leg is to be executed with ICMPs at a price of $25.03 and the particular stock market's BBO is $24.93 - $25.02). Such an execution would normally not be permitted unless an exception applies that permits the trade to be reported outside the BBO. The possibility of this scenario occurring exists with complex order executions and tied hedge transactions present nothing unique or novel in this regard. In the event market conditions continue to prevent the execution of a non-options leg(s) at the agreed price(s), the trade(s) representing the options leg(s) of a tied hedge transaction may ultimately be cancelled in accordance with CBOE rules (*see* Rule 6.48). Please also be aware that, in the event of a cancellation, members may be exposed to the risk associated with holding the hedge position that was obtained prior to presenting the tied hedge package in the trading crowd.

- Written Notification: Prior to entering tied hedge orders on behalf of customers, the member or member organization must deliver to the customer a one-time written notification informing the customer that his order may be executed using CBOE's tied hedge procedures. The written notification must disclose the terms and conditions contained in the tied hedge procedures and be in a form approved by the Exchange. Notifications must also be retained under the books and records requirements. The following text may be used by members and member organizations to satisfy this requirement:

> When handling an option order of 500 contracts or more on your behalf, [firm] may buy or sell a hedging stock, security futures or futures position following receipt of the option order but prior to announcing the option order to the trading crowd. The option order may thereafter be executed using the Chicago Board Options Exchange's tied hedge procedures. These procedures permit the option order and hedging position to be presented for execution as a net-priced package subject to certain requirements. For further details on the operation of the procedures, please refer to Chicago Board Options Exchange Rule 6.74.10, which is available at www.cboe.org/Legal.

Members may submit alternative forms of notification for approval by mail or email to the attention of Tim MacDonald, Member and Regulatory Services, 312-786-7706, macdonat@cboe.com.

For more information on tied hedge requirements, please refer to Rule 6.74.10 or rule filing SR-CBOE-2009-007, which are both available at www.cboe.org/legal. Further questions may be directed to Jennifer Lamie, Legal Division, at 312-786-7576.