



Regulatory Circular RG11-079

TO: Trading Permit Holders - Compliance Departments
FROM: Registration & Regulatory Services Division/Legal Division
RE: Compliance with Section 11(a) of the Securities Exchange Act of 1934 and the Rules Thereunder and the Application of Section 11(a) to the Hybrid System
DATE: June 29, 2011

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 (referred to in the Exchange Rules as "Trading Permit Holders").

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 any member of a national securities exchange from effecting any transaction on such 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, 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 trading for covered accounts must qualify pursuant to one of the other exemptions.

“G Order” Exemption

Section 11(a)(1)(G) and Rule 11a1-1(T) exempt 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), and the member discloses to any member to whom the order is transmitted that the order is a proprietary order (a so-called “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. Reliance on the “G” exemption for open outcry transactions requires yielding to any interest in the book to ensure that non-member interest is protected. Further, members intending to rely on the “G” exemption for electronic orders submitted into the Hybrid System must be aware that the only effective manner to yield to non-member interest is to mark such orders as IOC so they do not rest on the book (the System, for allocation purposes, is not programmed to execute resting non-member orders ahead of orders intending to rely on the “G” exemption).³ Accordingly, members should not submit orders in reliance of the “G” exemption in classes for which the “N-second group” timer is in effect pursuant to Rules 6.45A(c)(ii) and 6.45B(c)(ii).

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.

³ In addition, in the case of qualified contingent cross orders (“QCC Orders,” which are paired buy and sell orders that are to be executed immediately without exposure in accordance with CBOE Rule 6.53(u)), a member intending to rely on the “G” exemption must price the QCC Orders at a price that improves the Exchange’s best bid or offer on the same side of the market to effectively yield to non-member interest.

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
- 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).⁴ In contrast, if the member submitted the order to its “house” broker on the trading floor, the restrictions of Section 11(a) would apply and a different exemption would be necessary.

With respect to proprietary orders electronically transmitted to the Exchange’s Hybrid System by members from off the floor for automatic execution, processing and/or booking, the SEC has previously stated (in connection with other trading systems) that the condition that the executing broker may not be associated with the initiating member can be satisfied when automated exchange facilities are used and the design of the automated facilities ensure that members do not possess special or unique trading advantages in handling their orders after transmission. The Exchange believes that the Hybrid System meets these requirements.

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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.

(Updates Regulatory Circular RG09-35)

⁴ The exemption is also preserved if the unaffiliated broker inputs the order into the Hybrid System.