

Regulatory Circular RG13-098

Date: July 10, 2013

To: Trading Permit Holders

From: Department of Market Regulation

RE: **Notice Regarding Changes to CBOE Stock Exchange ("CBSX") Rule 53.2: Prohibition Against Trading Ahead of Customer Orders**

Overview

On May 2, 2013, the Securities and Exchange Commission approved CBOE's rule change to CBOE Stock Exchange ("CBSX") Rule 53.2 (currently titled "Trading Permit Holders Acting as Brokers", to be retitled "Prohibition Against Trading Ahead of Customer Orders"). The effective date of this rule change is July 22, 2013. Until such date, the rule's current requirements are still in force.

Although the amended rule still includes customer order protection, it now incorporates a number of exceptions to the rule. Most notably, Trading Permit Holders ("TPHs") with customers whose accounts that meet the definition of an "institutional account", as defined by the rule, or for orders of 10,000 shares or more (unless such orders are less than \$100,000 in value), a TPH is permitted to trade a security on the same side of the market for its own account at a price that would satisfy such customer order, provided that the TPH has provided clear and comprehensive written disclosure to such customer at account opening and annually thereafter that (1) discloses that the TPH may trade proprietarily at prices that would satisfy the customer order; and (2) provides the customer with a meaningful opportunity to opt in to the Rule 53.2 protections with respect to all or any portion of its order. If the customer does not opt in to the Rule 53.2 protections with respect to all or any portion of its order, the TPH may reasonably conclude that such customer has consented to the TPH trading a security on the same side of the market for its own account at a price that would satisfy the customer's order. In lieu of providing written disclosure to customers at account opening and annually thereafter, a TPH may provide clear and comprehensive oral disclosure to and obtain consent from the customer on an order-by-order basis, provided that the TPH documents who provided such consent and such consent evidences the customer's understanding of the terms and conditions of the order.

The amended rule also includes a "No Knowledge" exception. With respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS, if a TPH implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. A TPH that structures its order handling practices in NMS stocks to permit its proprietary and/or market-making desk to trade at prices that would satisfy customer orders held by a separate trading unit must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the TPH and the circumstances under which the TPH may trade proprietarily at its proprietary and/or market-making desk at prices that would satisfy the customer order.

If a TPH intends to rely on the "No Knowledge" exception by implementing information barriers as outlined in CBSX Rule 53.2, those information barriers must (1) provide for the organizational separation of a TPH's customer order trading unit and proprietary trading unit; (2) ensure that one trading unit does

not exert influence over the other trading unit; (3) ensure that information relating to each trading unit's stock positions, trading activities, and clearing and margin arrangements is not improperly shared (except with persons in senior management who are involved in exercising general managerial oversight of one or both entities); (4) require each trading unit to maintain separate books and records (and separate financial accounting); (5) require each trading unit to separately meet all required capital requirements; (6) ensure the confidentiality of the trading unit's book as provided by Exchange rules; and (7) ensure that any other material, non-public information (e.g. Information related to any business transactions between the trading unit and an issuer or any research reports or recommendations issued by the trading unit) is not made improperly available to the other trading unit in any manner that would allow that trading unit to take undue advantage of that information while trading on CBSX.¹ A TPH must submit the proposed information barriers in writing to the Exchange upon request.

In addition, the amended rule includes an Intermarket Sweep Order (ISO) Exception and an Odd Lot and Bona Fide Error Transaction Exception.

Please note that a TPH must have certain written procedures in place, and for certain exceptions, specified requirements must be met in order for a TPH to avail itself of such exceptions. Please see the rule's requirements on the CBOE website at: <https://www.cboe.com/publish/RuleFilingsSEC/SR-CBOE-2013-027.pdf>.

Contact Information

TPHs that have any questions on this circular may contact CBOE Regulatory Interpretations and Guidance at (312) 786-8141 or email RegInterps@cboe.com.

¹ In order to avail itself of the "No Knowledge" exception by implementing information barriers, these seven requirements must all be met. Pending SEC approval, the Exchange intends to submit a rule change which would propose eliminating requirements: (4) "must require each trading unit to maintain separate books and records (and separate financial accounting)" and (5) "must require each trading unit to separately meet all required capital requirements." If approved, a circular will be issued advising of this change.