

Regulatory Circular RG99-224

Date: December 7, 1999

To: Members

From: Regulatory Services Division

Re: Frontrunning of blocks

This Regulatory Circular presents the Exchange's enforcement policy with respect to certain practices generally referred to as "frontrunning of blocks".

Because a block transaction in an underlying security may have an impact on the market for that security or the options covering that security, the Exchange would be concerned if a member or member organizations were to engage or assist in the practice of trading in options or in underlying securities while in possession of material nonpublic information concerning imminent block transactions in these underlying securities. In keeping with its responsibility to assure the fairness of its market, the Exchange wishes to emphasize that this kind of activity may be conduct inconsistent with Exchange Rule 4.1, Just and Equitable Principles of Trade.

Although it is not possible to provide an all-inclusive definition of frontrunning in all of its forms, the Exchange believes that it is important to provide standards describing the kind of conduct that will not be permitted, both in order to provide guidance for members and to avoid interfering with entirely legitimate transactions that do not involve frontrunning. For this purpose, the Exchange has prepared this circular discussing the kind of conduct involving the frontrunning of blocks that would be considered to be in violation of Rule 4.1. It must be recognized that the following discussion of prohibited conduct is not exclusive, and that conduct not specifically described in this circular may nonetheless constitute frontrunning that comes within the broad prohibition of Rule 4.1.

The Exchange considers it to be conduct inconsistent with Just and Equitable Principles of Trade in violation of Rule 4.1 for a member or person associated with a member for an account in which such member or person has an interest, or for an account with respect to which such member or person exercises investment discretion, to enter or to cause to be executed:

- (1) an order to buy or sell an option when such member or person causing such order to be executed is in possession of material nonpublic information concerning an imminent block transaction in the underlying security, or
- (2) an order to buy or sell an underlying security when such member or person causing such order to be executed is in possession of material nonpublic information concerning an imminent block transaction in the underlying security prior to the time information concerning the block transaction(s) has been made publicly available. Frontrunning may

be based upon knowledge of less than all of the terms of the transaction(s), so long as there is knowledge that all of the material terms of the transaction(s) have been or will imminently be agreed upon. This prohibition similarly applies to members or member firms engaging in such transaction(s) in open outcry rather than by orders.

The possession, disclosure or acquiring of block information prior to its public dissemination is not alone a violation of the frontrunning prohibition. Selective disclosure of stock information may violate Rule 4.1, Just and Equitable and Principles of Trade. A frontrunning violation occurs when the possessor or acquiror performs the acts noted as 1 or 2 above based upon the nonpublic information they now possess.

Acting as Principal and Agent Regarding a Customer Order

If a member receives a customer's order of block size relating to both an option and the underlying security at or about the same time, the member may facilitate both components of the order, subject to applicable exchange rules governing crosses, and be exempt from waiting for the stock to print before doing the options. However, if the member only facilitates the stock component, the member would not be able to cover any resulting proprietary stock position by entering an offsetting option order or same side of the market option or stock order until information concerning all underlying block transactions have been made publicly available.

Acting Solely as Agent for a Customer Order

Although this circular concentrates on proprietary trading of members, frontrunning violations may occur in certain agency situations, such as where a member passes on nonpublic information concerning block transactions to a customer who then trades on the basis of the information. However, the Exchange generally will not consider it to be frontrunning, when in an agency capacity, a member, in executing a customer stock/option order of block size within the confines of existing stock and option markets, executes the option side of the order with knowledge that the material terms of the stock side of the order have been or will imminently be agreed upon.

The application of this circular is limited to transactions that are required to be reported on a last sale reporting system including those administered by CTA, OPRA and NASDAQ, and information as to a block transaction shall be considered to be publicly available when it has been disseminated via the tape or high speed communication line of one of those systems. Public outcry on the Exchange Floor shall not be deemed to make such information publicly available except in unusual circumstances with the advance approval of two Floor Officials.

A transaction involving 10,000 shares or more of an underlying security shall be conclusively deemed to be a block transaction although transactions of less than 10,000 shares may also be considered block transactions in appropriate cases. A block transaction that has been agreed upon does not lose its identity as such by arranging partial execution of the transaction in portions which themselves are not of block size. In this situation, the requirement that information concerning the transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported.

Buy/write programs and stock/options transactions on opposite sides of the market do not generally constitute violative activity. However, there can be exceptions. For example, if a firm is solicited by another firm to participate on the buy side of an imminent block of stock, at a price lower than the current market price and if the solicited firm sells calls prior to buying the stock, it

could be considered a violation of the frontrunning prohibition, notwithstanding the buy/write position it has established.

Regarding self-frontrunning, if a firm's options trading prior to effecting proprietary block transactions was found to have been calculated to take advantage of options participants who were unaware of the market impact of the impending proprietary transaction, the Exchange may find that this constituted frontrunning. Similarly, options trading designed to take advantage of the options market prior to proprietary index-related programs -- for example, trading options prior to unwinding proprietary arbitrage programs that "move the market" at expiration, could be interpreted as frontrunning. Such findings, would depend on all of the facts of the specific case and would of course, be decided on a case-by-case basis.

Matters involving possible violations of the frontrunning prohibition will continue to be addressed by the Exchange on a case-by-case basis, taking into consideration the facts in each particular situation, including but not limited to (1) the extent of available public information, (2) the amount of time between the stock and option trades, (3) the related time of entering orders in the component stocks of the underlying index, and (4) the number, size, and market impact of the stock transaction(s).

Any questions concerning this circular should be directed to Steven M. Slawinski (312) 786-7744 or Greg R. Rich (312) 786-7847.

(May 13, 1992, Regulatory Circular 92-29 Reissued)