



Date: October 26, 2009

To: Members

From: Division of Member and Regulatory Services

Re: Supervisory Obligations of Members Providing Access to Exchange Systems

The purpose of this Regulatory Circular is to highlight certain supervisory obligations of members when providing client access to Exchange systems.

Members are required to comply with all applicable securities laws and Exchange rules and regulations when submitting orders to the Exchange for execution via any Exchange system. Pursuant to various Exchange Rules, including CBOE Rules 4.1, 4.2, 6.20A and/or 9.8,<sup>1</sup> members must also supervise their associated persons and clients so as to assure compliance with these requirements. Each system of supervision must be tailored to the particular business type of the member. In this regard, it is important to remember that a member is responsible for every order submitted to the Exchange on its behalf whether by its associated persons or its clients.

The Exchange believes it is important for members providing access to the Exchange systems to have adequate procedures and controls in place to monitor and supervise the entry of orders to minimize the potential for errors and misuse of Exchange systems. Below is a list of procedures the Exchange recommends to assist members in addressing these concerns.

#### Procedures to Minimize Erroneous Client Transmissions

To minimize the potential for erroneous client transmissions, the Exchange recommends that members providing access to the Exchange systems implement procedures and controls that include, but are not limited to, the following:

- Each order is submitted by an authorized person, *i.e.*, the member's electronic system includes effective password protections or other comparable security measures.
- Each order does not exceed pre-set parameters including size, *i.e.*, the member's electronic system includes built-in system blocks for orders exceeding pre-defined size parameters (as established by the member in the course of conducting due diligence for the account).
- Each order entered into the Exchange complies with CBOE Rule 6.24, which pertains to the Consolidated Options Audit Trail System ("COATS"), *i.e.*, the member's electronic system includes built-in system checks designed to ensure each order contains the information required by Rule 6.24.
- Sponsoring Members that provide facilities for Sponsored User clients to directly access Exchange Systems must, pursuant to CBOE Rule 6.20A(b), have reasonable procedures to ensure that Sponsored User clients maintain the physical security of the Exchange and

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<sup>1</sup> Please see also CBOE Regulatory Circular RG97-98 (July 31, 1997) which, among other things, sets out regulatory requirements governing the entry of orders over Exchange systems.

Exchange systems and otherwise comply with Exchange Rules. In addition, Sponsored User clients must have: reasonable security measures to prevent unauthorized use of or access to Exchange systems and adequate procedures and controls to monitor use of and access to Exchange systems as provided under CBOE 6.20A(b)(ii) (see, e.g., the bullet points above for examples of such procedures and controls). The word “adequate” in this circumstance means that members must assure themselves that their Sponsored User clients’ written order entry procedures are reasonable under the particular circumstances of the Sponsored User client.

#### Reviewing Client Activity for Manipulative or Improper Trading Practices

To minimize the potential for misuse of Exchange systems, the Exchange recommends that members providing access to the Exchange systems have procedures in place designed to review any client trading activity on Exchange systems for potentially manipulative or otherwise improper trading practices. These procedures may be implemented on a post-trade basis. Supervisory reviews for manipulative and improper trading practices can be conducted via exception reports and other post-trade reviews of documents showing trade activity. These procedures should be designed to alert a member to potentially abusive or improper client trading patterns or practices. Any such patterns or practices discovered must be reviewed. Members that discover a pattern of improper client activity should not continue to provide access to that client and should report the activity to the Department of Market Regulation.

#### Member Responsibility

Members are encouraged to include a provision in their client agreements that makes clear each client’s responsibility to comply with all applicable securities laws and Exchange rules and regulations when submitting orders to the Exchange. Sponsored User clients are required to agree to this in writing as part of the Sponsored User provisions under CBOE Rule 6.20A(b)(1)(ii)(C).

Notwithstanding any such contractual language, any member that provides client access to the Exchange systems retains the responsibility and disciplinary liability for ensuring that client orders comply with all applicable securities laws and Exchange rules and regulations. Incidents of prohibited conduct may result in disciplinary action being taken against the member, even when committed by persons associated with a client.

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Please note that this Regulatory Circular is intended only to highlight certain procedures and controls designed to monitor and supervise the entry of orders to minimize the potential for errors and misuses. It is not intended to be a comprehensive description relating member supervisory procedures.

Please also note that the SEC is currently reviewing market structure issues including direct market access. In order to develop a new sponsored access rule that could be consistently applied across all markets, the Nasdaq Stock Market filed a proposal with the SEC to modify its rule requirements for members that provide sponsored access. The SEC issued a Notice asking for comment on Nasdaq’s proposed rule change.<sup>2</sup> If approved by the SEC, it is anticipated that other exchanges would file similar rule changes. Depending on what action is taken, the Exchange may make changes to this circular and/or its rules in the future with respect to these issues.

Any questions regarding this memorandum may be directed to Ji Min Kim at (312) 786-7043, or Tanja Samardzija at (312) 786-7722, in the Department of Market Regulation.

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<sup>2</sup> See Securities Exchange Act Release No. 59275 (January 22, 2009), 74 FR 5193 (January 29, 2009)(SR-NASDAQ-2008-104).