Regulatory Circular RG 95-49

Date: June 14, 1995

To: Members and Member Firms

From: Regulatory Services Division

Re: Floor Brokerage Practices

PREFACE

The Chicago Board Options Exchange ("CBOE") Regulatory Services Division, in conjunction with the Equity, OEX and SPX Floor Procedure Committees, has prepared this Regulatory Circular ("Circular") summarizing CBOE policy with respect to certain floor brokerage practices relating to option activity. This Circular is being issued to assist floor brokers in understanding their responsibilities under CBOE Rules and Securities and Exchange Commission ("SEC") Rules. This document is not all inclusive and does not supplant existing CBOE Rules and Interpretations and Policies as published in the CBOE Rule Book. Members are expected to be familiar with CBOE and SEC Rules governing floor brokerage practices and related recordkeeping requirements. These Rules are located primarily in Chapters VI, VII and XV of the CBOE Rule Book and in SEC Rules 17a-3 and 17a-4.

This Circular supersedes the June 19, 1986 Circular "Handling Agency Orders."

REPRESENTATION OF ORDERS

Floor brokers and firms representing customer orders have a fiduciary obligation to their clients to execute orders on the CBOE floor at the best available prices, in accordance with the Rules. The general obligations of a floor broker or a firm representing a customer order are addressed in CBOE Rule 6.73 ("Responsibilities of Floor Brokers") and include the following:

Representation of Bids & Offers:
(See RG91-24)

Rule 6.73.04 states in part, that "a Floor Broker's use of due diligence in handling an order shall include the immediate and continuous representation of market or marketable limit orders at the trading station where the option class represented by the order is traded." This means that a floor broker must insure that all market or marketable limit orders are constantly represented in the crowd either by himself or by another floor broker for as long as that order is active.

Floor Broker Responsibilities Under the Firm Disseminated Market Quote Rule:

CBOE's Rule relating to firm disseminated quotes (Rule 8.51) requires disseminated markets to be good for at least ten contracts in designated series. Pursuant to Rule 6.73.03, a floor broker must take the necessary measures to ensure the proper execution of an order by holding the crowd to its disseminated market quote.

Priority of Orders in a Floor Broker's Deck:

Pursuant to the due diligence provisions of Rule 6.73, a floor broker's agency business always takes priority over trades for his error account. The priority of like agency orders entered simultaneously with a floor broker may be determined by that individual floor broker, but, nonetheless, the floor broker is required to use due diligence to execute those orders at the best available price or prices.

SEPARATION OF THE MARKET-MAKER AND FLOOR BROKER

CBOE Rules generally prohibit a member from trading as a market-maker with respect to option contracts traded at a particular station on the same day that the member is acting as a floor broker at that station. (The word "station" is synonymous with the term "trading crowd".) This restriction is set forth in CBOE Rule 8.8 ("Restriction on Acting as a Market-Maker and Floor Broker"). CBOE Rules concerning the separation of the market-maker and floor broker functions with respect to warrants and other securities are set forth in Chapter 30 of the CBOE's Rules. A floor broker may only effect transactions for his own account at a station where he is acting as floor broker when he has a bona fide error.

In order to ensure this separation of the market-maker and floor broker functions, the following practices must be adhered to:

Legging Orders:

CBOE Rules do not prohibit legging of multi-part orders, provided that the legged trade is effected in accordance with CBOE Rules concerning use of due diligence and separation of the market-maker and floor broker functions. Multi-part orders include option to option orders, as well as stock and option and futures and option orders. The separation of the market-maker and floor broker functions has been interpreted by the CBOE's Regulatory Services Division and the Floor Procedure Committees to require that at the time a floor broker executes a leg of an option to option order, the price of the remaining leg of the order must be within the current disseminated market (e.g., when a floor broker executes the buy side, the price of the sell side of the order must be at the disseminated offer price or lower). If a floor broker determines that he is unable to complete an order he has legged he must either:

1) Offer the executed leg to the customer;

2) Liquidate the leg in open outcry and then offer the trade, regardless of whether it's a profit or loss, to the customer; or

3) Execute the remaining leg(s) of the order at the available market in open outcry and give the customer a difference check.

A floor broker may not provide an execution on the unexecuted portion of the order from his error account; by doing so, he is acting as a market-maker.

The floor broker must document the time and to whom the offer noted in 1) and 2) above was made and retain this record.

Stopping Orders:

It is improper for a floor broker to "STOP" or guarantee an execution to a customer order he is holding from his error account or deck. By doing so, a floor broker is acting as a market-maker and is in violation of CBOE Rule 8.8. Please note, however, that it is not a violation of Rule 8.8 for a floor broker to cross a public customer order with a facilitation order in accordance with the provisions of Rule 6.74(b) ("Crossing Orders").

Trading The Underlying Securities For Your Own Account:

CBOE Rules do not prohibit a floor broker from entering into transactions on other exchanges for his personal account in financial instruments underlying or related to the classes at the station where he acts as a floor broker. A related financial instrument would include index futures if you are an OEX or SPX floor broker, OEX options if you are an SPX floor broker, and SPX options if you are an OEX floor broker. Because trading in the underlying financial instrument could be perceived as a conflict of interest, the Equity and Index Floor Procedure Committees strongly advise against it. It would be a violation of CBOE Rules 4.1 ("Just and Equitable Principles of Trade") and 6.73 ("Responsibilities of Floor Brokers") and Regulatory Circular RG92-29 ("Frontrunning of Blocks") for a floor broker to enter into transactions in an underlying or related financial instrument based on information concerning a customer option order which he holds. Regulatory staff will monitor all such activity by floor brokers for possible violative activity. Floor broker transactions in underlying or related financial instruments are not entitled to good faith credit under Regulation T and must be margined as customer transactions.

RESOLUTION OF ERRORS AND OUT TRADES

In order to ensure that customers receive the best available price pursuant to CBOE Rule 6.73 ("Responsibilities of Floor Brokers") and in addition, in order to ensure that a floor broker clearly separates his market-maker and floor broker functions as set forth in CBOE Rule 8.8 ("Restriction on Acting as Market-Maker and Floor Broker") the following policies are to be adhered to:

Print-Throughs:

A print-through on a limit order occurs when a trade is effected at a better price than the order's limit during the time that the order should have been represented in the crowd. The customer is entitled to the number of contracts which trade through the order's limit up to the number of contracts specified in his order. The price to which the customer is entitled is described below. Generally, the customer should be given a better price if it is available at the time the error is discovered. However, under certain circumstances, such as a systems failure, where a large number of orders were not received or receipt was delayed, it would not be improper for a firm to fill the customer's order at the original limit price rather than the better price. A floor broker should generally proceed as follows when a print-through has occurred:

1) If a floor broker discovers a print-through **during trading hours** and a better price is available at that time, the customer should be filled at the better price. If a better price is no longer available, then the floor broker is responsible at the original limit price and the floor broker may either execute the order at the available market and give the customer a "difference check" or fill the order out of his error account, **provided it does not reduce or liquidate a position in the error account**. (See section on **Liquidation of Error Account Positions** for correct procedure.)

2) If a print-through is discovered **outside trading hours** and the customer requires a fill as of that trade date, the floor broker may fill the customer at the limit price out of his error account. If the customer does not require a fill as of that trade date, the floor broker must wait until the following trade date and proceed as described in paragraph one. If the customer is filled out of the error account outside trading hours and this results in the reduction or liquidation of a position in the error account, this must be reported in writing to the Department of Market Regulation before 10:00 a.m. CT the following morning, and such report must be accompanied by supporting documentation.

3) If a print-through occurs **on the opening**, the customer is generally entitled to the number of contracts which print through at the opening price. If a better price than the opening price is available at the time the error is discovered, the customer should be filled at the better price; if a better price is not available, the floor broker may either fill the order at the opening price out of his error account, **provided it does not reduce or liquidate a position in the error account,** or execute the order at the available market and give the customer a "difference check."

Lost Or Misplaced Market Orders:

If a floor broker fails to execute a market order, the customer is entitled to an execution on up to ten contracts at the disseminated bid or offer at the time the order was received in the crowd or at a better price if it is available at the time the error is discovered. If a better price or the price the customer is entitled to is not available at the time the error is discovered, the floor broker should provide a fill in the manner described in the above section on **Print-Throughs**. If the unexecuted market order is in excess of ten contracts, the execution price on the additional contracts should be negotiated between the floor broker and customer.

Orders Executed Erroneously:

If a floor broker incorrectly executes an order (for example, he executes a call order as a put or a buy order as a sell order) the erroneous trade must clear in the floor broker's error account. As described in CBOE Rule 6.61.04 ("Reconciliation and Resolution of Unmatched Trades") it is inconsistent with CBOE Rule 4.1 ("Just and Equitable Principles of Trade") for a member to accept a transaction in which the accepting party was not involved. This means, among other things, that a floor broker may not give a trade acquired through an error to another member. If the customer's order was entitled to a fill, it should be provided in the manner described in the above sections titled **Print-Throughs** or **Lost Or Misplaced Market Orders**.

In all of the situations described above, if the floor broker effects a trade for his error account as a result of a bona fide error, thereby establishing a position in his error account (resulting in a risk position), any profit/loss from liquidating this error account position belongs to the floor broker. (See the sections on **DOCUMENTATION OF ERRORS** and **RECORD KEEPING REQUIREMENTS**.)

Liquidation of Error Account Positions:

Except as provided above in the paragraph concerning print-throughs discovered outside trading hours, a floor broker may not reduce or liquidate an error account position by crossing his error account with an order he is holding. If a floor broker needs to reduce or liquidate a position in his error account and the best bid or offer is an order he is holding, the floor broker (the "liquidating floor broker") must give his order to liquidate the error account position to an unassociated floor broker, or, where there is no unassociated floor broker, he must give the customer order to the Order Book Official or DPM. In any event, the customer bid or offer must be either displayed on the book or announced in open outcry and other members must be given a reasonable opportunity to participate in the trade. (An unassociated floor broker, for purposes of this Circular, is any floor broker who is not directly or indirectly controlling, controlled by, or under common control with the liquidating floor broker.)

Resolution of Out-Trades:

As previously noted, CBOE Rule 6.61 ("Reconciliation and Resolution of Unmatched Trades") states that it is inconsistent with just and equitable principles of trade for any member, or person associated with a member, to accept a transaction in which he was not involved. A floor broker who has an out-trade is prohibited from giving the out-trade to or clearing the trade with a member who was not involved in the transaction which resulted in the out-trade. Further, it is improper to add a trade that was not the result of a bona fide error or to decline to accept any transaction in which the declining party or its principal was involved. (See section on **<u>RECORD KEEPING REQUIREMENTS</u>** for information on documentation.)

<u>DOCUMENTATION OF ERRORS</u>

All transactions executed for a floor broker error account must be recorded on an order ticket. A brief description of the error which necessitated the trade, the time the error was discovered and the initials of the individual creating this record must also be written on the order. These records must be retained for a minimum of three years, the first two years in an easily accessible place. (See **<u>RECORD KEEPING REQUIREMENTS</u>**.) In addition, the Independent Floor Broker Task Force has recommended that floor brokers also keep out-trade sheets relating to all errors.

<u>RECORD KEEPING REQUIREMENTS</u>

Rules adopted by the SEC under the Securities Exchange Act of 1934 (the "Act") require that a floor broker keep a copy of every order he receives, including orders received via hand signals or phone, and all cancels and nothing dones. A floor broker may arrange to have these records kept on his behalf; however, it is still the responsibility of the floor broker to produce such documents upon request. These records must be retained for a minimum of three years, the first two years in an easily accessible place. Failure to do so is a violation of the Act, SEC Rules 17a-3 and 17a-4, and CBOE Rules 4.2 ("Adherence to Law") and 15.1 ("Maintenance, Retention and Furnishing of Books, Records and Other Information").

As previously announced, the Regulatory Services Division will be conducting audits of floor brokers. At a minimum, the following records <u>will be requested when an audit is initiated</u>: copies of all orders executed by the floor broker, copies of all orders the floor broker received but were canceled or returned "nothing done", and all order tickets representing trades for an error account.

CONCLUSION

This Circular describes the CBOE's policies with respect to the floor brokerage practices described herein. Failure to adhere to SEC or CBOE Rules as described in this Circular will subject a member to possible disciplinary action.

If you have any questions concerning these matters contact Ann Grady at (312) 786-7733 or Margaret E. Williams at (312) 786-7834 in the Exchange's Department of Market Regulation.

(Regulatory Circular RG94-44 Reissued)