



August 15, 2013

**Via Electronic Mail ([rule-comments@sec.gov](mailto:rule-comments@sec.gov))**

Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: File No. SR-CBOE-2013-074; Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to CBSX Rule 53.2

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> appreciates the opportunity to provide the Securities and Exchange Commission (“Commission”) with comments on the above referenced filing. In that filing, the Chicago Board Options Exchange (“CBOE”) proposed amendments to CBOE Stock Exchange (“CBSX”) Rule 53.2, which governs trading ahead of customer orders. SIFMA supports the amendments in the proposed rule change because they increase the consistency between CBSX Rule 53.2 and Rule 5320 of the Financial Industry Regulatory Authority (“FINRA”), which governs the same issue. However, CBSX and FINRA rules are not identical, which SIFMA believes undermines the longstanding efforts to develop a single set of uniform self-regulatory organization (“SRO”) rules to govern member regulation. Because of these differences, CBSX member firms could face inconsistent interpretations with their compliance under similar but not identical rule sets. Accordingly, SIFMA believes that CBOE should amend CBSX Rule 53.2 further so that it is identical to FINRA Rule 5320.

### **Background – Centralizing Member Firm Regulation**

As the Commission is aware, centralized member regulation has been a goal of regulators and industry members for a number of years.<sup>2</sup> In 2007, FINRA was created through the

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<sup>1</sup> The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

<sup>2</sup> See, e.g., Statement by SEC Chairman Cox at News Conference on Self Regulation Consolidation (November 28, 2006), available at <http://www.sec.gov/news/press/2006/2006-195.htm>.

consolidation of the member regulation operations of the National Association of Securities Dealers (“NASD”) and the New York Stock Exchange (“NYSE”). SIFMA was a strong supporter of this consolidation, and we believe it has contributed to decreasing unnecessary duplication and inconsistency in member regulation, while preserving investor protection and important regulatory interests.<sup>3</sup> As the Commission recognized in approving the creation of FINRA, the goal of NASD and NYSE in consolidating their member regulation operations was to create “the sole U.S. private-sector provider of member firm regulation for securities firms that conduct business with the public.”<sup>4</sup>

As a national securities association, FINRA has been particularly suited to be the central SRO for member regulation because every broker-dealer that does business with customers must be a FINRA member. Section 15(b)(8) of the Securities Exchange Act of 1934 (“Exchange Act”) provides that a broker-dealer may not effect transactions in securities unless it is “a member of a securities association registered pursuant to section [15A of the Exchange Act] or effects transactions in securities solely on a national securities exchange of which it is a member.” Rule 15b9-1(a) under the Exchange Act provides a narrow exception to this requirement, stating that:

Any broker or dealer required by section 15(b)(8) of the [Exchange Act] to become a member of a registered national securities association shall be exempt from such requirement if it: (1) Is a member of a national securities exchange, (2) carries no customer accounts, and (3) has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than \$1,000.

The practical effect of Rule 15b9-1 is to allow broker-dealers that trade solely for their own account to become exchange members without joining FINRA. Taken together, however, Section 15(b)(8) and Rule 15b9-1 effectively require broker-dealer with any customer business to join FINRA and become subject to its rules.

### **FINRA Rule 5320 – Establishing a Consistent Standard for Customer Order Protection**

Ever since its creation in 2007, FINRA has been engaged in a comprehensive effort to consolidate the legacy NASD and NYSE rulebooks into a single, harmonized set of SRO rules on member regulation. A significant chapter in the rulebook harmonization process was the adoption of FINRA Rule 5320, which prohibits trading ahead of customer orders. Before the adoption of Rule 5320, broker-dealers that were members of both FINRA and NYSE remained subject to two different sets of rules on customer order protection: NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market

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<sup>3</sup> See, e.g., Letter from Amal Aly, Managing Director and Associate General Counsel, SIFMA to Nancy M. Morris, Secretary, Commission, dated August 22, 2007 (“Proposed Rule Change Relating to the Harmonization of NYSE and NASD Regulatory Standards”).

<sup>4</sup> See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007).

Orders), and NYSE Rule 92 (Limitations on Members' Trading Because of Customers' Orders). FINRA harmonized the two sets of rule into Rule 5320.

The Commission approved FINRA Rule 5320 on February 11, 2011. In approving Rule 5320, the Commission stated that it:

believes that the proposed rule change is designed to establish a single standard to protect customer orders from member firms trading ahead of those orders. By consolidating the current NASD and NYSE order protection rules, the Commission believes that the proposed rule change would reduce the complexity of the customer order protection rules for those firms subject to both sets of rules. Furthermore, the Commission believes that the proposed rule will help assure the protection for customer orders without imposing undue regulatory costs on industry participants.<sup>5</sup>

Before FINRA Rule 5320 took effect, NYSE adopted its own version, consistent with the FINRA rule, and eliminated legacy NYSE Rule 92.<sup>6</sup> As SIFMA stated at the time, we believe that FINRA Rule 5320 was a substantial step forward in FINRA's efforts at rule harmonization, and we agree with the Commission that standardization provides significant benefits to industry participants.<sup>7</sup> In addition, FINRA Rule 5320 served the purpose of applying a uniform standard to all applicable broker-dealers because any broker-dealer with a customer order in need of protection must be a member of FINRA pursuant to Section 15(b)(8) of the Exchange Act and Rule 15b9-1 thereunder.

On a more specific level, the adoption of FINRA Rule 5320 harmonized the knowledge standards under the legacy NASD and NYSE rules. NYSE Rule 92, by its terms, addressed circumstances where the person responsible for the entry of a proprietary order had knowledge of a customer's order that could be executed at the same price. The legacy NASD rules established a "no-knowledge" interpretation, which permitted broker-dealers to trade at prices without filling pending customer orders at the same price if the broker-dealer implemented and utilized an effective system of internal controls, such as appropriate information barriers.<sup>8</sup> FINRA Rule 5320 follows the approach of the legacy NASD rules, and it includes a "no-knowledge" exception. The exception provides, in relevant part, that:

if a member implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent one trading unit from

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<sup>5</sup> Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011).

<sup>6</sup> Securities Exchange Act Release No. 65164 (August 18, 2011), 76 FR 53015 (August 24, 2011).

<sup>7</sup> See Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA to Marcia E. Asquith, Office of the Corporate Secretary, FINRA Dated April 30, 2009 ("Response to FINRA Regulatory Notice 09-15 and NYSE Information Memo 09-13").

<sup>8</sup> 76 FR at 9388.

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 member that structures its order handling practices in NMS stocks to permit its 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 member and the circumstances under which the member may trade proprietarily at its market-making desk at prices that would satisfy the customer order.<sup>9</sup>

### **CBSX Rule 53.2 – Diverging from Rulebook Harmonization**

In the context of the FINRA rulebook harmonization process, CBSX Rule 53.2 stands out as an anomaly. Rule 53.2 was originally adopted in 2006,<sup>10</sup> prior to the creation of FINRA. When it was adopted, Rule 53.2 was modeled after NYSE Rule 92, and it included a “knowledge” component as part of the rule itself.<sup>11</sup> CBOE proposed to amend CBSX Rule 53.2 in March 2013, and one of the amendments was to replace the “knowledge” component of the rule with a “no-knowledge” exception.<sup>12</sup> Unlike the corresponding exception in FINRA Rule 5320, however, CBSX Rule 53.2 included several specific conditions on the use of information barriers under the no-knowledge exception. In its proposal, CBOE stated that “these specific information barrier requirements will clarify for [CBSX members] what types of information barriers would be deemed appropriate information barriers and thus better allow [CBSX members] to rely on [the no-knowledge] exception.”<sup>13</sup> In practical effect, however, the conditions would have created substantial compliance obligations for CBSX member firms rather than providing

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<sup>9</sup> FINRA Rule 5320.02(a).

<sup>10</sup> See Securities Exchange Act Release No. 34-54422 (September 11, 2006), 71 FR 54537 (September 15, 2006); see also Securities Exchange Act Release No. 34-55392 (March 2, 2007), 72 FR 10572 (March 8, 2007); Securities Exchange Act Release No. 34-62382 (June 25, 2010), 75 FR 38164 (July 1, 2010).

<sup>11</sup> Specifically, CBSX Rule 53.2(a) provided that:

No Trading Permit Holder shall on the CBSX System (1) personally buy or initiate the purchase of any security subject to the rules in these Chapters for his own account or for any account in which he or his TPH organization or any member, partner, officer, or employee is directly or indirectly interested, while such Trading Permit Holder personally holds or *has knowledge* that his TPH organization or any member, partner, officer or employee holds an unexecuted market order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security subject to the rules in these Chapters for any such account, while he personally holds or *has knowledge* that his TPH organization or any member, partner, officer or employee holds an unexecuted market order to sell such security in the unit of trading for a customer.

See Securities Exchange Act Release No. 69146 (March 15, 2013), 78 FR 17454 (March 21, 2013) (emphasis added).

<sup>12</sup> *Id.* at 17549.

<sup>13</sup> *Id.*

clarification. In addition, as noted above, any CBSX member that has a customer order in need of protection must be a FINRA member and therefore is already subject to FINRA Rule 5320. The differences between CBSX Rule 53.2 and FINRA 5320 that the Commission approved in May are particularly confusing because, through the same proposed rule change, CBOE proposed, and the Commission approved amendments to CBSX Rule 53.8 on best execution to make it identical in all substantive respects to FINRA's corresponding rule, Rule 5310.

In its proposed rule change filed on July 19, 2013 and referenced above, CBOE eliminated many, but not all, of the conditions on the no-knowledge exception under CBSX Rule 53.2.<sup>14</sup> While the basic no-knowledge requirement of Rule 53.2.02 is substantively identical to FINRA Rule 5320.02(a),<sup>15</sup> the CBSX rule continues to include enumerated conditions that are not included in FINRA Rule 5320.02. Specifically, Rule 53.2 provides that:

If a Trading Permit Holder intends to rely on [the no-knowledge] exception by implementing information barriers, those information barriers should at a minimum (i) provide for the organizational separation of a Trading Permit Holder's customer order trading unit and proprietary trading unit; (ii) ensure that one trading unit does not exert influence over the other trading unit; (iii) ensure that information relating to each trading unit's stock positions and trading activities is not improperly shared (except with persons in senior management who are involved in exercising general managerial oversight of one or both entities); (iv) ensure the confidentiality of the trading unit's book as provided by Exchange rules; and (v) 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. A Trading Permit Holder must submit the proposed information barriers in writing to the Exchange upon request.

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<sup>14</sup> See Securities Exchange Act Release No. 34-70011 (July 19, 2013), 78 FR 44994 (July 25, 2013)

<sup>15</sup> CBSX Rule 53.2 provides, at the outset, that:

With respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS, if a Trading Permit Holder 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 Trading Permit Holder 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 Trading Permit Holder and the circumstances under which the Trading Permit Holder may trade proprietarily at its proprietary and/or market-making desk at prices that would satisfy the customer order.

See also *supra*, text accompanying note 9 (quoting FINRA Rule 5320.02(a)).

CBOE's filing to eliminate several of the conditions that were initially set forth under the CBSX no-knowledge exception reduced many of the unnecessary compliance burdens that would have resulted from the significant differences between CBSX Rule 53.2 and FINRA Rule 5320. However, CBOE's recent filing does not explain the reason for the continuing differences between CBSX Rule 53.2 and FINRA Rule 5320. SIFMA appreciates the amendments that CBOE has made, but we remain concerned that the differences between the rules could result in inconsistent interpretations for CBSX member firms for their compliance with two different SRO rules intended to address the same type of conduct.<sup>16</sup> As such, CBOE should amend CBSX Rule 53.2 further to eliminate the conditions so that Rule 53.2 is substantively identical to FINRA Rule 5320. More broadly, the distinctions between the two rules undermine the longstanding and continuing efforts to centralize member firm regulation and harmonize the applicable SRO rules.

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<sup>16</sup> The substantial differences between CBSX Rule 53.2 and FINRA Rule 5320 unnecessarily call into question whether CBSX members could rely on longstanding FINRA interpretations of the no-knowledge exception, for example that a broker-dealer may use information barriers to rely on the no-knowledge exception for trading within a single aggregation unit.

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SIFMA greatly appreciates the opportunity to provide the Commission with these comments. We appreciate CBOE's efforts to increase the consistency of CBSX Rule 53.2 with FINRA Rule 5320, but we urge CBOE to make further amendments to that the rules are fully harmonized. Should you have any questions, please contact me at ( [REDACTED] or [REDACTED] ) or Timothy Cummings at ( [REDACTED] or [REDACTED] ).

Sincerely,



Theodore R. Lazo  
Managing Director and  
Associate General Counsel  
SIFMA

cc: Mary Jo White, Chair  
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