

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53331; File No. SR-CBOE-2006-17)

February 17, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Extend a Pilot Program Relating to Market-Maker Bid-Ask Width Requirements for Non-Hybrid System Classes

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on February 15, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The CBOE has filed this proposal pursuant to Section 19(b)(3)(A)(iii) of the Act³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to extend until February 17, 2007, a pilot program establishing a limited exemption from the bid/ask differential requirements of CBOE Rule 8.7(b)(iv). The text of the proposed rule change appears below. Proposed new language is underlined; proposed deletions are [bracketed].

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A)(iii).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ The CBOE has asked the Commission to waive the 30-day operative delay provided in Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

Chicago Board Options Exchange, Incorporated Rules

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Rule 8.7. Obligations of Market-Makers

(a)-(e) No Change

... Interpretations and Policies:

.01-.12 No Change

.13 Market-Makers will be exempt from the requirements of subparagraph (b)(iv) of this Rule for a period of 30 seconds in cases where the Exchange automatically adjusts one side of the disseminated quote to one minimum increment below (above) the NBBO bid (offer): (1) because the size associated with that quote has been exhausted by automatic executions; or (2) to comply with the terms of the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage. This exemption will be in effect until [February 17, 2006] February 17, 2007 on a pilot basis.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing to extend until February 17, 2007, a pilot program that provides a limited exemption from the Market-Maker bid/ask differential requirements contained in CBOE Rule 8.7(b)(iv).⁶ As part of accommodating compliance with the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (the "Linkage Plan"),⁷ the Exchange introduced an "autofade" functionality for classes NOT trading on the CBOE's Hybrid platform ("Hybrid") (there are currently fewer than 10 classes that are not on Hybrid).⁸ Because dynamic quoting is a feature of the Hybrid system, it does not require the autofade enhancement. Autofade causes one side of the CBOE's disseminated quote to move to an inferior price when the quote is required to fade pursuant to the terms of the Linkage Plan and/or when the size associated with the quote has been depleted by automatic Retail Automatic Execution System ("RAES") executions (of both Linkage orders and non-Linkage orders). Without this enhancement, the system would not change the quote as required.

Linkage orders are generally Immediate or Cancel limit orders priced at the national best bid or offer ("NBBO") that must be acted upon within 15 seconds. The Linkage Plan provides

⁶ The Commission approved the pilot program on September 10, 2003. See Securities Exchange Act Release No. 48471 (September 10, 2003), 68 FR 54251 (September 16, 2003) (order approving File No. SR-CBOE-2003-08). The pilot program was subsequently extended for an additional 18 months, until February 17, 2006. See Securities Exchange Act Release No. 50292 (August 31, 2004), 69 FR 54167 (September 7, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2004-39).

⁷ The Commission approved the Linkage Plan on July 28, 2000. See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000).

⁸ Hybrid is the CBOE's trading platform that allows individual Market Makers to submit electronic quotes in their appointed classes. See CBOE Rule 1.1(aaa).

several instances in which a Participant receiving a Linkage order must fade its quote. For example, if a Participant receives a Principal Acting as Agent ("PA") order for a size greater than the Firm Customer Quote Size and does not execute the entirety of the PA Order within 15 seconds, the Participant is required to fade its quote. The CBOE's autofade functionality automates the fading process to ensure that members (and the Exchange) are in full compliance with this aspect of the Linkage Plan. Autofade moves the CBOE's quote to a price that is one tick inferior to the NBBO.⁹ This ensures that the Exchange will not immediately receive additional Linkage orders to allow the quote to refresh (either manually or through an autoquote update).

As mentioned above, autofade also applies any time an automatic execution of any order via RAES has depleted the size of the CBOE's quote. Once a quote is exhausted, autofade moves the quote to a price that is one tick inferior to the NBBO, as described above. For equity option classes that are not trading on the Hybrid System, the CBOE quote is generally derived from an autoquote system that is maintained by the Designated Primary Market-Maker ("DPM"). Certain DPMs utilize an Exchange-provided autoquote system, while others employ proprietary autoquote systems. In either case, the autoquote system calculates bid and ask prices that are transmitted to the Exchange for dissemination to the Options Price Reporting Authority ("OPRA"). The DPM and the trading crowd separately input the size associated with the bid/ask prices. When an automatic execution occurs through the RAES system, the size associated with the quote is decremented until it is exhausted. However, because the autoquote system is only calculating prices and not quote sizes, the autoquote system is not aware that the size has been

⁹ The only exception is when CBOE's NBBO quote (or next best quote) is represented by a customer order in the book. In such cases, the Exchange does not fade a booked order (it would have to be traded).

exhausted (or in the case of a remaining balance on a Linkage order, that the quote needs to fade in order to comply with the Linkage Plan). Therefore, the autofade functionality was built to override autoquote and move the quote price to one tick inferior to the NBBO. The “override” period only lasts for 30 seconds. However, the override can be overridden during that 30-second time period if the quote is manually updated by a trader or if the autoquote system transmits new bid/ask pricing to the Exchange.

The exemption established by the pilot program is for limited instances where the autofade functionality moves the quote in a manner that causes the quote width to widen beyond the bid/ask parameters provided in CBOE Rule 8.7(b)(iv). The CBOE seeks to extend on a pilot basis the temporary exception to the requirements of CBOE Rule 8.7(b)(iv) in cases where autofade causes a quote that exceeds the quote width parameters of that rule. The proposed exemption period lasts for a maximum of 30 seconds after any given autofade that caused a quote wider than allowed under CBOE Rule 8.7(b)(iv). Thus, to the extent a quote remained outside of the maximum width after the 30-second time period, the responsible broker or dealer disseminating the quote would be deemed in violation of CBOE Rule 8.7(b)(iv) for regulatory purposes. The CBOE proposes to extend the pilot for one more year, until February 17, 2007.

2. Statutory Basis

The CBOE believes that the proposed rule change will, among other things, allow the Exchange to more easily comply with the requirements of the Linkage Plan. Accordingly, the Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,¹⁰ in general, and furthers the objectives of Section 6(b)(5) of the Act,¹¹ in particular, in that it should promote just and equitable principles of trade, serve to remove impediments to, and perfect the

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

mechanism of, a free and open market and a national market system, and protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The CBOE neither solicited nor received comments on the proposal.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The CBOE has designated the proposed rule change as one that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date of filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. In addition, as required under Rule 19b-4(f)(6)(iii),¹² the CBOE provided the Commission with written notice of its intention to file the proposed rule change, along with a brief description and the text of the proposed rule change, at least five business days prior to filing the proposal with the Commission. Therefore, the foregoing rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹³ and Rule 19b-4(f)(6) thereunder.¹⁴

Pursuant to Rule 19b-4(f)(6)(iii) under the Act, a proposal does not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. The CBOE has asked the

¹² 17 CFR 240.19b-4(f)(6)(iii).

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

Commission to waive the 30-day operative delay to allow the pilot program to continue without interruption.

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest because it will allow the pilot program to continue to operate without interruption through February 17, 2007.¹⁵ Accordingly, the Commission waives the 30-day operative delay.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-17 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

¹⁵ For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

All submissions should refer to File No. SR-CBOE-2006-17. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-CBOE-2006-17 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Nancy M. Morris
Secretary

¹⁶ 17 CFR 200.30-3(a)(12).