

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60665; File No. SR-CBOE-2009-052)

September 14, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order
Approving a Proposed Rule Change Related to the Hybrid Matching Algorithms

On July 17, 2009, the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend CBOE Rules 6.45A and 6.45B to adopt a modified participation entitlement overlay to orders executed electronically on the CBOE Hybrid System (“Hybrid System”). The proposed rule change was published for comment in the Federal Register on August 10, 2009.³ The Commission received no comments on the proposed rule change. This order approves the proposed rule change.

CBOE Rules 6.45A and 6.45B set forth, among other things, the manner in which electronic Hybrid System trades in options are allocated. Paragraph (a) of each rule essentially governs how incoming orders received electronically by the Exchange are electronically executed against interest in the CBOE quote. Paragraph (a) of both rules currently provides for several different matching algorithms, including price-time and pro-rata priority matching algorithms with additional priority overlays.⁴ The priority overlays currently include: public

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 60420 (August 3, 2009), 74 FR 39989.

⁴ Rules 6.45A and 6.45B also include the Ultimate Matching Algorithm (“UMA”). CBOE did not propose any changes to the UMA in this filing.

customer priority, market turner priority, and participation entitlements for certain qualifying market-makers.⁵ These overlays are optional.

The purpose of the rule filing is to adopt the “modified participation entitlement,” an additional optional priority overlay for the price-time and pro-rata matching algorithms. The modified participation entitlement will operate in the same manner as the existing participation entitlement for certain qualifying market-makers; however, if at the time of execution there is one or more public customer orders resting at the execution price but none was entered first in time sequence, then the market-maker participation entitlement and public customer priority overlays would not be applied to the allocation - i.e. the allocation would revert back to the price-time or pro-rata methods. The participation entitlement for certain qualifying market-makers would therefore only be applied to the execution of an inbound order if there are no public customer orders resting on the Hybrid System at the best price or if a public customer was

⁵ Under the existing participation entitlements, the Exchange may determine to grant market-makers participation entitlements pursuant to the provisions of Rules 8.87, Participation Entitlement of DPMs and e-DPMs; 8.13, Preferred Market-Maker Program; or 8.15B, Participation Entitlement of LLMs. More than one such participation entitlement may be activated for an option class (including at different priority sequences), however in no case may more than one participation entitlement be applied on the same trade. In allocating the participation entitlement, all of the following apply: (i) to be entitled to its participation entitlement, the market-maker’s order and/or quote must be at the best price on the Exchange; (ii) the market-maker may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price (if pro-rata priority is in effect, and the market-maker's allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted, the market-maker shall not receive any further allocation of that order); (iii) in establishing the counterparties to a particular trade, the participation entitlement must first be counted against that market-maker's highest priority bids or offers; and (iv) the participation entitlement shall not be in effect unless the public customer priority is in effect in a priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance. See Rules 6.45A(a)(ii)(2) and 6.45B(a)(i)(2).

the first to rest interest at the best price, in which case the public customer order would have priority over the order of the market maker. This outcome is a change from how the existing participation entitlement works today.⁶

The Commission has carefully reviewed the proposed rule change and finds that it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁸ which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The new priority overlay is the same as the current market-maker participation entitlement overlay, except that the participation entitlement will only be applied if there are no public customer orders resting at the best price or if a public customer was the first to rest interest at the best price. Otherwise, neither the current public customer priority overlay nor the market-maker participation entitlement priority overlay will be in effect. Thus, public customer orders will have priority over the orders of other market participants if they are the first orders

⁶ For example, assume the matching algorithm for an options class is established so that public customer orders have first priority, the modified participation entitlement has second priority, and any remaining balance is allocated using the pro-rata matching algorithm. If, at the time of execution, there is one or more public customer orders at the execution price but none is first in time sequence (for instance, because a market-maker quote was the first trading interest posted at the execution price), then the market-maker participation entitlement and public customer priority overlays would not be applied and the incoming order would be allocated solely on a pro-rata basis.

⁷ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f(b)(5).

entered at the best price; if they are not the first orders at the best price, then the order will be allocated among market participants using the underlying matching algorithm—price-time or pro-rate—both of which the Commission already has found as consistent with the Act.⁹ The Commission therefore believes that the modified participation entitlement priority overlay is consistent with the Act.

⁹ See Securities Exchange Act Release No. 51822 (June 10, 2005), 70 FR 35321 (June 17, 2005) (Adopting CBOE Rule 6.45B).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰ that the proposed rule change (SR-CBOE-2009-052), be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹¹

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Deputy Secretary

¹⁰ 15 U.S.C. 78s(b)(2).

¹¹ 17 CFR 200.30-3(a)(12).