

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60957; File No. SR-CBOE-2009-070)

November 6, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order
Approving a Proposed Rule Change Relating to Preferred Market Makers

I. Introduction

On September 28, 2009, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² a proposal to amend CBOE Rule 8.13, “Preferred Market-Maker Program” to establish a participation entitlement for complex orders designated to Preferred Market Makers and to clarify the operation of the Hybrid System with respect to the existing Preferred Market Maker participation entitlement for individual options orders. The proposed rule change was published for comment in the Federal Register on October 7, 2009.³ The Commission received no comments regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposal

The CBOE proposes to amend CBOE Rule 8.13 to: (1) establish a participation entitlement for complex orders entered into the Complex Order Book (“COB”) or the complex order RFQ auction (“COA”) that are designated to a Preferred Market Maker; and (2) clarify the operation of the Hybrid System with respect to the Preferred Market Maker participation entitlement for individual options orders.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 60746 (September 30, 2009), 74 FR 51626 (“Notice”).

A. Participation Entitlement for Complex Orders

Under the proposal, any Designated Primary Market Maker, Lead Market Maker, or Market Maker with an appointment/allocation in the relevant options class may be designated as a Preferred Market Maker for complex orders.⁴ A Preferred Market Maker must comply with the quoting obligations applicable to its Market Maker type under CBOE's rules and must provide continuous electronic quotes (as defined in CBOE Rule 1.1(ccc)) in at least 90% of the series of each class for which it receives Preferred Market Maker orders.⁵ In addition, to receive a participation entitlement for orders entered into the COB, the Preferred Market Maker must be quoting at the best net priced bid/offer when the order is received.⁶ For orders in a COA, the Preferred Market Maker must: (1) at the beginning of the auction, be quoting at either (A) the best bid/offer on the CBOE in at least one of the component series of the complex order, or (B) the best net priced bid/offer for the complex order; and (2) be quoting at the best net priced bid/offer at the conclusion of the auction.⁷

CBOE prohibits an order flow provider from notifying a Preferred Market Maker of its intention to submit a preferenced complex order so that the Preferred Market Maker could change its quotation to match the national best bid or offer ("NBBO") immediately prior to the submission of the preferenced order.⁸ CBOE states that CBOE Rule 4.18, "Prevention of the Misuse of Material, Nonpublic Information," prohibits this misuse of material non-public

⁴ See CBOE Rule 8.13, Interpretation and Policy .01(a).

⁵ See CBOE Rule 8.13, Interpretation and Policy .01(c).

⁶ See CBOE Rule 8.13, Interpretation and Policy .01(a)(ii)..

⁷ See CBOE Rule 8.13, Interpretation and Policy .01(a)(iii).

⁸ See Notice, supra note 3, at note 3.

information.⁹ CBOE represents that it will conduct surveillance for, and enforce against, such violations.¹⁰

The participation entitlement for a complex order is based on the contracts remaining after equivalent net priced orders and quotes on the EBook and equivalent net priced public customer complex orders resting in the COB that have priority over Preferred Market Makers have been filled.¹¹ After these orders have been filled, the participation entitlement for a Preferred Market Maker that satisfies the requirements in CBOE Rule 8.13, Interpretation and Policy .01 is: (1) 40% when there are two or more Market Makers also quoting at the best net priced bid/offer execution price; and (2) 50% when there is one other Market Maker quoting at the best net priced bid/offer execution price.¹² The participation entitlement percentages for complex orders are the same as the participation entitlement percentages for individual options orders currently provided under CBOE Rule 8.13(c). If a Preferred Market Maker receives a participation entitlement for a complex order in the COB or a COA, no other participation entitlement provided in the CBOE's rules for complex orders will apply to the complex order.¹³

B. Clarification of the Participation Entitlement for Individual Orders

CBOE is amending CBOE Rule 8.13(b) to more clearly reflect the operation of the Hybrid System with respect to Preferred Market Makers. Specifically, CBOE is revising CBOE

⁹ Id.

¹⁰ Id.

¹¹ See CBOE Rule 8.13, Interpretation and Policy .01(b)(ii).

¹² See CBOE Rule 8.13, Interpretation and Policy .01(b).

¹³ See CBOE Rule 8.13, Interpretation and Policy .01(b)(iii). However, if a complex order executes, in part, against a Preferred Market Maker's interest in the COB or the COA and, in part, against the Preferred Market Maker's interest in the individual series legs in the EBook, a Preferred Market Maker entitlement may apply on both the individual series legs and on the COB or COA execution. See Notice, supra note 3, at note 5.

Rule 8.13(b) to indicate that the Hybrid System is programmed so that the recipient of a Preferred Market Maker order will receive a participation entitlement if: (1) the Preferred Market Maker has an appointment/allocation in the relevant options class; and (2) the Preferred Market Maker is quoting at the CBOE's best bid or offer. CBOE is adding paragraph (d) to CBOE Rule 8.13, which will incorporate the quoting obligations applicable to Preferred Market Makers that are currently set forth in CBOE Rule 8.13(b)(iii), including the requirement that a Preferred Market Maker provide continuous electronic quotes, as defined in CBOE Rule 1.1(ccc), in at least 90% of the series of each class for which it receives Preferred Market Maker orders. CBOE notes that this quoting obligation, like other Market Maker quoting obligations, is subject to CBOE market performance, surveillance, and disciplinary programs to assess and enforce compliance.

III. Discussion and Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁴ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁵ which requires, in part, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to 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. The proposal establishes a Preferred Market Maker participation entitlement for complex orders submitted to the COB and the COA. Under the proposal, the Preferred Market Maker participation

¹⁴ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(5).

entitlement percentages for complex orders are the same as the Preferred Market Maker participation entitlement percentages provided currently in CBOE Rule 8.13(c) for individual options orders.¹⁶ Because the proposal does not provide a participation entitlement for complex orders that is greater than the currently acceptable participation entitlement threshold for individual options orders, the Commission does not believe that the proposal will negatively impact quote competition for complex orders on CBOE. Under the proposal, the remaining portion of each complex order will still be allocated based on the competitive bidding of market participants.

A Preferred Market Maker must satisfy certain requirements to be eligible for a participation entitlement in complex orders. Specifically, a Preferred Market Maker must comply with the quoting obligations applicable to its Market Maker type under the CBOE's rules and must provide continuous electronic quotes (as defined in CBOE Rule 1.1(ccc)) in at least 90% of the series for each class for which it receives Preferred Market Maker orders.¹⁷ In addition, to receive a participation entitlement for orders entered into the COB, the Preferred

¹⁶ The Commission also has approved similar participation entitlement percentages for individual options orders on other options exchanges. *See, e.g.*, Securities Exchange Act Release Nos. 56269 (August 15, 2007), 72 FR 47086 (August 22, 2007) (File No. SR-Amex-2007-75) (order approving an American Stock Exchange directed order program that provides a 40% participation entitlement on directed orders) ("Amex Order"); 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (File No. SR-Phlx-2004-91) (order approving a directed order program on the Philadelphia Stock Exchange that allows the directed order recipient to receive a 40% participation entitlement on designated orders) ("Phlx Order"); and 51818 (June 10, 2005), 70 FR 35146 (June 16, 2005) (File No. ISE-2005-18) (order approving a preferencing program on the International Securities Exchange that allows a preferred market maker to receive a 40% participation entitlement on designated orders).

¹⁷ *See* CBOE Rule 8.13, Interpretation and Policy .01(c). This quoting obligation also applies currently to the Preferred Market Maker participation entitlement for individual options orders.

Market Maker must be quoting at the best net priced bid/offer when the order is received.¹⁸ For orders in a COA, the Preferred Market Maker must: (1) at the beginning of the auction, be quoting at either (A) the best bid/offer on the CBOE in at least one of the component series of the complex order, or (B) the best net priced bid/offer for the complex order; and (2) be quoting at the best net priced bid/offer at the conclusion of the auction.¹⁹ These quoting requirements are analogous to the current requirement in CBOE Rule 8.13(b)(ii) that a Preferred Market Maker be quoting at the CBOE's best bid/offer to be eligible for a participation entitlement for an individual options order.

The Commission believes that it is critical that, to be eligible for a participation entitlement for a complex order, a Preferred Market Maker may not step up and match the CBOE's best bid/offer after it receives an order, but must be publicly quoting at the CBOE's best net priced bid/offer when the order is received (for orders in the COB), or, for orders in a COA, quoting at either the CBOE's best/bid offer for a least one component of a complex order or at the CBOE's best net priced bid/offer for the complex order at the start of the auction.²⁰ As noted above, CBOE states that it would be a misuse of material non-public information in violation of CBOE Rule 4.18 for an order flow provider to notify a Preferred Market Maker of its intention to submit a preferenced complex order immediately prior to sending the order to allow the

¹⁸ See CBOE Rule 8.13, Interpretation and Policy .01(a)(ii).

¹⁹ See CBOE Rule 8.13, Interpretation and Policy .01(a)(iii).

²⁰ A Preferred Market Maker will not be allocated a total quantity greater than the quantity it is quoting at the best net priced bid/offer execution price. See CBOE Rule 8.13, Interpretation and Policy .01(b)(i).

Preferred Market Maker to modify its quotation.²¹ CBOE represents that it will conduct surveillance for, and enforce against, such violations of its rules.²²

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. The Commission has discussed the duty of best execution in previous orders approving proposals to implement participation entitlements,²³ and hereby incorporates those discussions by reference into this order.

Finally, the Commission finds that the changes to CBOE Rule 8.13(b) are consistent with the Act because they clarify the operation of the Hybrid System with respect to Preferred Market Maker participation entitlements.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (File No. SR-CBOE-2009-070) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Florence E. Harmon
Deputy Secretary

²¹ See notes 8 and 9, supra, and accompanying text.

²² See note 10, supra, and accompanying text.

²³ See, e.g., Amex Order and Phlx Order, supra note 16; and Securities Exchange Act Release No. 51779 (June 2, 2005), 70 FR 33564 (June 8, 2005) (File No. SR-CBOE-2004-71) (order approving a modification of the participation entitlement for Preferred Designated Primary Market Makers).

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).