

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50924; File No. SR-CBOE-2004-67)

December 23, 2004

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change and Amendment No.1 thereto Relating to Split Price Priority

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 20, 2004, the Chicago Board Options Exchange, Incorporated (“CBOE” or the “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. On December 17, 2004, CBOE amended the proposed rule change (“Amendment No. 1”).<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

CBOE proposes to amend its split price trading rule. The text of the proposed rule change, as amended, is set forth below. Proposed new language is in italics; deletions are in [brackets].

---

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, CBOE amended the proposed rule change to: (i) remove the parenthetical “(or a reasonably larger number)” from current CBOE Rule 6.47(a) and from the proposed rule text of CBOE Rule 6.47(b); and (ii) revise proposed Interpretations and Policies .01 to clarify that if a floor broker is required to yield, he must yield to “orders for the accounts of non-members.”

\* \* \* \* \*

**Rule 6.47. Priority on Split Price Transactions Occurring in Open Outcry**

(a) Purchase or sale priority. If a member purchases (sells) one or more option contracts of a particular series at a particular price or prices, he shall, at the next lower (higher) price at which a member other than the Board Broker or Order Book Official is bidding (offering), have priority in purchasing (selling) up to the equivalent number [(or a reasonably larger number)] of option contracts of the same series that he purchased (sold) at the higher (lower) price or prices, but only if his bid (offer) is made promptly and the purchase (sale) so effected represents the opposite side of a transaction with the same order or offer (bid) as the earlier purchase or purchases (sale or sales). This paragraph only applies to transactions effected in open outcry.

(b) [Sale priority. If a member sells one or more option contracts of a particular series at a particular price or prices, he shall, at the next higher price at which a member other than the Board Broker or Order Book Official is offering, have priority in selling up to the equivalent number (or a reasonably larger number) of option contracts of the same series that he sold at the lower price or prices, but only if his offer is made promptly and the sale so effected represents the opposite side of a transaction with the same order or bid as the earlier sale or sales. This paragraph only applies to transactions effected in open outcry.] Purchase or sale priority for orders of 100 contracts or more. If a member purchases (sells) fifty or more option contracts of a particular series at a particular price or prices, he shall, at the next lower (higher) price have priority in purchasing (selling) up to the equivalent number of option contracts of the same series that he purchased (sold) at the higher (lower) price or prices, but only if his bid (offer) is made promptly and the purchase (sale) so effected represents the opposite side of a transaction with the same order or offer (bid) as the earlier purchase or purchases (sale or sales). The appropriate

Exchange committee may increase the “minimum qualifying order size” above 100 contracts for all products under its jurisdiction. Announcements regarding changes to the minimum qualifying order size shall be made via Regulatory Circular. This paragraph only applies to transactions effected in open outcry.

**(c) No Change**

**Interpretations and Policies.....**

.01 Floor brokers are able to achieve split price priority in accordance with paragraphs (a) and (b) above. Provided, however, that a floor broker who bids (offers) on behalf of a non-market-maker CBOE member broker-dealer (“CBOE member BD”) must ensure that the CBOE member BD qualifies for an exemption from Section 11(a)(1) of the Exchange Act or that the transaction satisfies the requirements of Exchange Act Rule 11a2-2(T), otherwise the floor broker must yield priority to orders for the accounts of non-members.

\* \* \* \* \*

**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, as amended, 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 parts of such statements.

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

1. Purpose

CBOE Rule 6.47 establishes priority principles for split-price transactions. Generally, a member buying (selling) at a particular price shall have priority over other members in purchasing (selling) up to an equivalent number of contracts of the same order at the next lower (higher) price. Awarding split price priority serves as an inducement to members to bid (offer) more aggressively for an order that may require a split-price execution by giving them priority at the next lower (higher) price point. For example, assume the market is \$1.00 – 1.20, 300-up when a floor broker (“FB”) receives instructions from a customer that it would like to buy 500 options at a price or prices no higher than \$1.20. The FB could attempt to execute the order in open outcry at a price better than the displayed market of \$1.20. Assume a market maker (“MM”) in the crowd is willing to sell 250 contracts at \$1.15 provided he can also sell the remaining 250 contracts at \$1.20. Under current rules, that MM could offer \$1.15 for 250 contracts and then, by virtue of the split price priority rule, he/she would have priority for the balance of the order (up to 250 contracts) over other crowd members. If executed, the resulting net price of \$1.175 is better than the current displayed market of \$1.20, which results in a better fill for the customer.<sup>4</sup>

One limitation on the ability of crowd participants to use the split price priority rule is the rule’s requirement that orders in the limit order book (“book”) have priority over the member attempting to fill the balance of the order at the split price. Using the example above, if the \$1.20 price represented orders in the book, those orders would have priority over the MM at

---

<sup>4</sup> If successful, two trades will be reported (at \$1.15 and 1.20) and the net price result to the customer will be \$1.175.

\$1.20. This means that a MM who is willing to trade at \$1.15 and \$1.20 may be completely unwilling to trade at the better price of \$1.15 if he/she cannot trade the balance of the order at \$1.20 because of the requirement to yield to existing customer interest in the book. This jeopardizes the FB's ability to execute the first part of the order at a price of \$1.15, thereby potentially making it difficult to achieve price improvement for the customer on CBOE. Instead, the order may trade at another exchange that has no impediments, i.e., no customer interest at those price levels. Accordingly, the purpose of this proposal is to adopt a limited exception to the existing priority requirement.

Under newly-proposed paragraph (b) to CBOE Rule 6.47, a member with an order for at least 100 contracts and who buys (sells) at least 50 contracts at a particular price would have priority over all others in purchasing (selling) up to an equivalent number of contracts of the same order at the next lower (higher) price.<sup>5</sup> Using the above example, the MM trading at \$1.15 would have priority over members and orders in the book at \$1.20 to trade at \$1.20 with the balance of the order in the trading crowd. The Exchange believes that the proposal would lead to more aggressive quoting by MMs, which in turn could lead to better executions. As indicated above, a MM might be willing to trade at a better price for a portion of an order if he/she were assured of trading with the balance of the order at the next pricing increment. As a result, FBs representing orders in the trading crowd might receive better-priced executions. As proposed, the appropriate Exchange committee would have the ability to increase the minimum qualifying order size to a number larger than 100 contracts. Any changes, which would have to apply to all

---

<sup>5</sup> Orders for less than 100 contracts would be unaffected by this proposal. The Exchange also would take the opportunity to consolidate current paragraphs (a) and (b) into one paragraph (paragraph (a)). This consolidation would not effect the operation of the rule in any way; it simply would make the rule shorter.

products under the committee's jurisdiction, would be announced to the membership via Regulatory Circular.

The Exchange believes that it would be reasonable to make a limited exception to the customer priority rule to allow split price trading. In this regard, the proposed exception would be similar in operation to the limited priority exception that exists for complex orders (contained in CBOE Rules 6.45 and 6.45A). The complex order priority exception generally provides that a crowd member affecting a qualifying complex order may trade ahead of the book on one side of the order provided the other side of the order betters the book. This exception was intended to facilitate the trading of complex orders, which by virtue of their multi-legged composition could be more difficult to trade without a limited exception to the priority rule for one of the legs. The purpose behind the proposed split-price priority exception is the same - - to facilitate the execution of large orders, which by virtue of their size and the need to execute them at multiple prices may be difficult to execute without a limited exception to the priority rules. The proposed exception would operate in the same manner as the complex order exception by allowing a member affecting a trade that betters the market to have priority on the balance of that trade at the next pricing increment, even if there are orders in the book at the same price.

To address potential concerns regarding Section 11(a) of the Act,<sup>6</sup> the Exchange proposes to adopt new Interpretations and Policies .01("I&P") to CBOE Rule 6.47. Section 11(a) generally prohibits members of national securities exchanges from effecting transactions for the member's own account, absent an exemption. With respect to the proposal, there could be situations where because of the limited exception to customer priority, orders on behalf of

---

<sup>6</sup> 15 U.S.C. 78k(a)

members could trade ahead of orders of nonmembers in violation of Section 11(a).<sup>7</sup> The proposed I&P would make clear that FBs may avail themselves of the split-price priority rule, but that they would be obligated to ensure compliance with Section 11(a). In this regard, a FB bidding (offering) on behalf of a non-market-maker CBOE member broker-dealer (“CBOE member BD”) would be required to ensure that the CBOE member BD qualifies for an exemption from Section 11(a)(1) of the Act or that the transaction satisfies the requirements of Rule 11a2-2(T). Otherwise, the FB would be required to yield priority to orders for the account of non-members. The Exchange further proposes to amend paragraph (a) of Rule 6.47 to remove the parenthetical (“or a reasonably larger number”).<sup>8</sup> The Exchange believes the language to be unnecessary to achieve the intent of the rule, which is to allow FBs to have priority for up to an equivalent number of contracts purchased or sold at the preceding price, as specified in the rule.

## 2. Statutory Basis

For the above reasons, the Exchange believes that the proposed rule change would enhance competition. Thus, CBOE believes that the proposal is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b)<sup>9</sup> of the Act. Specifically, the Exchange believes that the proposed rule change is consistent with the Section 6(b)(5)<sup>10</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest.

---

<sup>7</sup> For example, assume FB A walks into the trading crowd attempting to find a crowd member willing to effect a split-price transaction. FB B, who is representing either a proprietary or member BD order, expresses interest. In this instance, Section 11(a) could be implicated, absent an exemption.

<sup>8</sup> See Amendment No. 1

<sup>9</sup> 15 U.S.C. 78(f)(b).

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

CBOE does not believe that the proposed rule change, as amended, would impose any burden on competition 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 Exchange neither solicited nor received written comments on the proposed rule change.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, as amended, or

(B) institute proceedings to determine whether the proposed rule change, as amended, should be disapproved.

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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-67 on the subject line.

---

<sup>10</sup> 15 U.S.C. 78(f)(b)(5).

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-67. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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 Number SR-CBOE-2004-67 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.<sup>11</sup>

Margaret H. McFarland  
Deputy Secretary

---

<sup>11</sup> 17 CFR 200.30-3(a)(12).