

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67903; File No. SR-CBOE-2012-082)

September 21, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to Small Order Preference Priority Overlay

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 12, 2012, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Exchange has designated the proposal as a “non-controversial” proposed rule change pursuant to Section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder.⁴ 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 the Substance of the Proposed Rule Change

The Exchange is proposing to amend Rules 6.45A, Priority and Allocation of Equity Option Trades on the CBOE Hybrid System, and 6.45B, Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System, to expand on the description of the existing operation of the small order preference priority overlay. The text of the proposed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

rule change is available on the Exchange's website (www.cboe.org/Legal), at the Exchange's Office of the Secretary and at the Commission's Public Reference Room.

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 those 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 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 each rule currently provides a "menu" of matching algorithms to choose from when executing incoming electronic orders. The menu format allows the Exchange to utilize different matching algorithms on a class-by-class basis. The menu includes, among other choices, the ultimate matching algorithm ("UMA"), as well as price-time and pro-rata priority matching algorithms with additional priority overlays. The priority overlays for price-time and pro-rata currently include: public customer priority for public customer orders resting on the Hybrid System, participation entitlements for certain qualifying market-makers. Additional priority overlays for UMA, price-time and pro-rata

include the small order preference and a market turner priority (for participants that are first to improve CBOE's disseminated quote). These overlays are optional.

If the small order priority overlay is in effect for an option class, then the following applies:

- Orders for five (5) contracts or fewer will be executed first by the Designated Primary Market-Maker ("DPM") or Lead Market-Maker ("LMM"), as applicable, that is appointed to the option class; provided however, that on a quarterly basis the Exchange evaluates what percentage of the volume executed on the Exchange (excluding volume resulting from the execution of orders in AIM (see CBOE Rule 6.74A, Automated Improvement Mechanism ("AIM")) is comprised of orders for five (5) contracts or fewer executed by DPMs and LMMs, and will reduce the size of the orders included in this provision if such percentage is over forty percent (40%).
- This procedure only applies to the allocation of executions among non-customer orders and market maker quotes existing in the EBook at the time the order is received by the Exchange. No market participant is allocated any portion of an execution unless it has an existing interest at the execution price. Moreover, no market participant can execute a greater number of contracts than is associated with the price of its existing interest. Accordingly, the small order preference contained in this allocation procedure is not a guarantee; the DPM or LMM, as applicable, (i) must be quoting at the execution price to receive an allocation of any size, and (ii) cannot execute a greater number of contracts than the size that is associated with its quote.
- If a Preferred Market-Maker (see CBOE Rule 8.13, Preferred Market-Maker Program) is not quoting at a price equal to the national best bid or offer ("NBBO") at the time a preferred

order is received, the allocation procedure for small orders described above shall be applied to the execution of the preferred order. If a Preferred Market Maker is quoting at the NBBO at the time the preferred order is received, the allocation procedure that is generally applicable for all other sized orders contained in subparagraphs (a)(i) and (ii) of Rules 6.45A or 6.45B, as applicable, is applied to the execution of the preferred order (e.g., if the default matching algorithm is price-time with a public customer and participation entitlement overlay, the order will execution [sic] first against any public customer orders, then the Preferred Market-Maker would receive its participation entitlement, then the remaining balance would be allocated on a price-time basis).

- The small order priority overlay is only be [sic] applicable to automatic executions and is not be [sic] applicable to any electronic auctions.⁵

The purpose of the proposed rule change is to expand on the text contained in subparagraphs (a)(iii) of Rules 6.45A and 6.45B to simply make it clearer that, in the event an order for five contracts or fewer is received when there is a Preferred Market-Maker quoting at a price equal to the NBBO at the time a preferred order is received, any Market Turner priority overlay status would not be applied. Currently the rule text does not include this level of detail,⁶

⁵ In addition to AIM, CBOE has various electronic auctions that are described under Rules 6.13A, Simple Auction Liaison (“SAL”), 6.14A, Hybrid Agency Liaison (HAL), and 6.74B, Solicitation Auction Mechanism (“AIM SAM”). Each of these auctions generally allocates executions pursuant to the matching algorithm in effect for the options class with certain exceptions noted in the respective rules.

⁶ The rule text currently indicates that, “[i]f a Preferred Market Maker is quoting at the NBBO at the time the preferred order is received, the allocation procedure contained in subparagraphs (i) or (ii), as applicable, shall be applied.” Subparagraphs (i) and (ii) of Rules 6.45A and 6.45B describe the UMA, price-time, and pro-rata priority allocation algorithms (as well as the additional priority overlays applicable to the respective allocation algorithms). Subparagraph (iii) of Rules 6.45A and 6.45B describe the additional priority overlays applicable to all allocation methodologies, which overlays include the small order preference overlay and the Market Turner overlay.

so the Exchange is proposing to include this information within the rule to provide additional clarity on the existing operation of the small order preference overlay. Specifically, as revised, the text would provide that, in the event an order for five contracts or fewer is received when there is a Preferred Market-Maker quoting at a price equal to the NBBO at the time a preferred order is received, the allocation procedure contained in subparagraphs (a)(i) and (ii) of Rules 6.45A or 6.45B, as applicable, orders shall be applied to the execution of the preferred order (as the rule text already provides) and that any Market Turner priority overlay status (which is described in subparagraph (a)(iii)(2) of Rules 6.45A or 6.45B, as applicable) shall not be applied to that execution.

The operation of the small order priority overlay described above is part of CBOE's careful balancing of the rewards and obligations that pertain to each of the Exchange's classes of memberships. This balancing is part of the overall market structure that is designed to encourage vigorous price competition between Market-Makers (including DPMs, LMMs and Preferred Market-Makers) on the Exchange, as well as maximize the benefits of price competition resulting from the entry of customer and non-customer orders, while encouraging participants to provide market depth. The Exchange believes the small order priority overlay, which includes priority participation rights for DPMs and LMMs or Preferred Market-Makers (as applicable) over non-customer orders and market maker quotes only when the DPM/LMM or Preferred Market-Maker (as applicable) is quoting at the best price, strikes the appropriate balance within its market and maximizes the benefits of an electronic market for all participants. In that regard, the Exchange believes that allowing the Preferred Market-Maker participation entitlement to take precedence over any otherwise applicable Market Turner allocation (in the limited scenario where a preferred order for five contracts or fewer is received when there is a Preferred Market-

Maker quoting at a price equal to the NBBO at the time the preferred order is received) strikes the appropriate balance within its market and maximizes the benefits of an electronic market for all participants. In particular, the application of the Preferred Market-Maker participation entitlement under the small order preference priority overlay can contribute to market quality to the extent that it acts as an incentive to attract and retain Market-Maker participation on CBOE and, given the small order size and NBBO quoting requirement that are conditions to receiving the preference, CBOE believes that applying small order preference over Market Turner priority for these types of small orders is appropriate and consistent [sic] the protection of investors and the public interest.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act⁷ in general and furthers the objectives of Section 6(b)(5) of the Act⁸ in particular in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest. In particular, the Exchange believes that including the additional detail within the rules should provide additional clarity and avoid any confusion on the operation of the small order preference priority overlay in a class where the Market Turner priority overlay is also in effect. The Exchange also believes that the provision allowing the Preferred Market-Maker participation entitlement to take precedence over any otherwise applicable Market Turner allocation (in the limited scenario where a preferred order for five contracts or fewer is received when there is a Preferred Market-Maker quoting at a price equal to

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

the NBBO at the time a preferred order is received) strikes the appropriate balance within its market and maximizes the benefits of an electronic market for all participants. In particular, the application of the Preferred Market-Maker participation entitlement under the small order preference priority overlay can contribute to market quality to the extent that it acts as an incentive to attract and retain Market-Maker participation on CBOE and, given the small order size and NBBO quoting requirement that are conditions to receiving the preference, CBOE believes that applying small order preference over Market Turner priority for these types of small orders is appropriate and consistent [sic] the protection of investors and the public interest.

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

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 Exchange neither solicited nor received comments on the proposal.

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

Because the foregoing rule does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change or such shorter time as designated by the Commission, the proposed rule change has become effective pursuant to

Section 19(b)(3)(A) of the Act⁹ and Rule 19b-4(f)(6) thereunder.¹⁰ At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend 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-2012-082 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2012-082. 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

⁹ 15 U.S.C. 78s(b)(3)(A).

¹⁰ 17 CFR 240.19b-4(f)(6). As required under Rule 19b-4(f)(6)(iii), the Exchange provided the Commission with written notice of its intent 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 the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

comments on the Commission's Internet website (<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 website viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal offices 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 Number SR-CBOE-2012-082, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

Kevin M. O'Neill
Deputy Secretary

¹¹ 17 CFR 200.30-3(a)(12).