SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53167; File No. SR-CBOE-2005-89)

January 23, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change and Amendment No. 1 Thereto Relating to the Adoption of a Hybrid Agency Liaison System for Automated Handling of Inbound Orders That Are Not Automatically Executed

On October 27, 2005, 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 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to adopt a Hybrid Agency Liaison ("HAL") system for automated handling of inbound orders for option classes trading on CBOE's Hybrid System ("Hybrid"). On December 7, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The proposed rule change and Amendment No. 1 were published for comment in the Federal Register on December 15, 2005.[4] No comments were received regarding the proposal, as amended. This order approves the proposed rule change, as amended.

I. Description of the Proposal

Hybrid currently provides electronic executions on the Exchange for orders that are marketable against the Exchange's quote when it represents the National Best Bid or Offer ("NBBO"). The entire process for those orders is automated; however, many electronically-received orders that are not automatically executed upon receipt by the Hybrid System (usually

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Amendment No. 1 replaced the original filing in its entirety.

4 See Securities Exchange Act Release No. 52928 (December 8, 2005), 70 FR 74388 ("Notice").

because CBOE's disseminated quote is not the NBBO) are routed to a PAR terminal for manual handling.[5] In proposed CBOE Rule 6.14, the Exchange proposes to automate the handling process for certain orders in designated classes that would be routed to a PAR terminal under the current rules—specifically, market orders and limit orders that are marketable against CBOE's disseminated quote while that quote is not the NBBO, and limit orders that improve CBOE's disseminated quote (whether or not they are marketable against the NBBO). These orders would be electronically exposed to all CBOE Market-Makers appointed to the relevant option class as well as to all members acting as agent for orders at the top of the Exchange's book in the relevant option series ("Qualifying Members").[6] Like open outcry, this exposure and subsequent allocation period[7] (together, the "HAL auction" or "auction") would afford crowd members an opportunity to match the away NBBO price.[8]

If any portion of an exposed order remains unexecuted at the end of a HAL auction, then the remaining order would be booked if it is a limit order that is not marketable, or, if marketable, routed to the Exchange showing the NBBO via the options intermarket linkage. If the price of the Linkage Order is no longer available on any market, then HAL would execute the

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5 See CBOE Rule 7.12, PAR Officials (setting forth the rules for manual handling by the PAR Officials of orders routed to PAR terminals).

6 Of course, eligible recipients of these messages (CBOE Market-Makers and Qualifying Members) may need to undertake some programming modifications to receive and respond to these messages. The Exchange will not require those programming changes.

7 The allocation period affords Market-Makers and Qualifying Members that were interested in trading with an exposed order an opportunity to participate in the execution of an order following an exposure period. Each Market-Maker or Qualifying Member that submits an order or quote to trade with an order during the exposure or allocation periods would be entitled to receive an allocation of the order in accordance with the allocation algorithm in effect for the options class pursuant to CBOE Rule 6.45A or 6.45B. See proposed CBOE Rule 6.14(c).

8 For a full description of the operation of the proposed HAL auction, see Notice, supra note 4.

remainder of the order against the Exchange's existing quote provided such execution would not result in a trade-through. However, if the Exchange's quote is inferior to the Exchange's best bid or offer at the time the order was received by HAL ("Exchange Initial BBO"), then the order would be executed against the Market-Makers that constituted the Exchange Initial BBO at a price equal to the Exchange Initial BBO.

In addition, the proposal provides for early termination of an auction in certain cases—for instance, when the Hybrid System receives an unrelated order on the opposite side of the market from the exposed order that could trade against the exposed order at the prevailing NBBO price; when the Hybrid System receives an unrelated order on the same side of the market as the exposed order that is priced equal to or better than the exposed order; or, in the case of exposure of an order that is marketable against the Exchange Initial BBO, when a Market-Maker whose quote is part of the Exchange Initial BBO attempts to move its quote to an inferior price.[9] In this last case, the auction would terminate and the Exchange would not permit any Market-Maker quotes to move to an inferior price until the exposed order was routed through the Linkage or, if a superior price is no longer available on another exchange, executed at the Exchange Initial BBO against the Market-Makers that constituted the Exchange Initial BBO.[10]

II. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national

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[9] For a full discussion of the auction termination provisions in proposed CBOE Rule 6.14(d) and (e), see Notice, supra note 4.

[10] See proposed CBOE Rule 6.14(d)(iii) and (e)(iii).

securities exchange.[11] In particular, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be designed to 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.[12]

The Exchange noted in its proposal that the proposed Hybrid Agency Liaison system would be an improvement over open outcry auctions because HAL, an automated process, would reduce the duration of the auction to three seconds or less.[13] In addition, customer order protections built into proposed CBOE Rule 6.14 (such as, most significantly, the guarantee that the customer order will receive an execution at the Exchange Initial BBO if no better price is available when the auction ends or is terminated)[14] should guarantee that any order that is the subject of a HAL auction will be executed at a price at least as good as the price disseminated by the Exchange at the time the order was received by HAL.[15] Thus, the HAL auction provisions should ensure both that orders that are ineligible for automatic execution under the CBOE's rules because the CBOE is not at the NBBO are handled electronically rather than manually, and that CBOE Market-Makers honor their disseminated quotes, regardless of whether an auction has been initiated.

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

[12] 15 U.S.C. 78f(b)(5).

[13] CBOE's proposed Rule 6.14(b) limits the total exposure and allocation time to three seconds.

[14] See proposed CBOE Rule 6.14(b)(i), (b)(ii), (d)(iii), and (e)(iii).

[15] See proposed CBOE Rule 6.14(b)(i) and (ii).

In addition, the Commission notes that the Exchange proposes to incorporate into its proposed rule provisions that would provide that a pattern or practice of submitting unrelated orders that cause an exposure period to conclude early and the dissemination of information regarding exposed orders to third parties will be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1 and other Exchange rules.[16] The Commission believes that these provisions will require the CBOE to surveil for, and hopefully help to limit, any potential "gaming" of the HAL system.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[17] that the proposed rule change (File No. SR-CBOE-2005-89), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[18]

Nancy M. Morris
Secretary

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16 See proposed CBOE Rule 6.14, Interpretations and Policies .01 and .02.

17 15 U.S.C. 78s(b)(2).

18 17 CFR 200.30-3(a)(12).