SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54135; File No. SR-CBOE-2005-65)

July 12, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order
Approving Proposed Rule Change and Amendment Nos. 1 and 2 Relating to the Processing of
Complex Orders in the Hybrid Trading System

I.   Introduction

On August 24, 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, among other things, establish an automated Request for Responses

("RFR") auction process for eligible complex orders (a "COA" process) traded on the CBOE's

Hybrid Trading System ("Hybrid System") and to revise certain CBOE rules governing complex

orders. The proposed rule change, as amended by Amendment Nos. 1 and 2, was published for

comment in the Federal Register on June 7, 2006.[3] The Commission received no comments

regarding the proposal, as amended. This order approves the proposal, as amended.

II.   Description of the Proposal

        A. COA Process for Complex Orders

CBOE Rule 6.53C, "Complex Orders on the Hybrid System," sets forth the procedures

for trading complex orders on the CBOE's Hybrid System. Among other things, CBOE Rule

6.53C addresses whether a complex order will be routed to a PAR workstation, for manual

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

[2]   17 CFR 240.19b-4.

[3]   See Securities Exchange Act Release No. 53909 (May 31, 2006), 71 FR 33011
        ("Notice").

handling, or to the complex order book ("COB"), for automated handling, and, once in the COB, the manner in which a complex order will execute against orders or quotes in the EBook, orders resting in the COB, and orders submitted to trade against interest in the COB. The CBOE proposes to introduce the COA,[4] a new functionality designed to give eligible complex orders an opportunity for price improvement before being booked in the COB or once on PAR. The CBOE believes that the COA process will facilitate more automated handling of complex orders.

Under the COA process, when a COA is initiated for a COA-eligible order,[5] the CBOE will send an RFR message to all members who have elected to receive RFR messages.[6] Market Makers with an appointment in the relevant options class and members acting as agent for orders resting at the top of the COB in the relevant options series may submit responses to the RFR message ("RFR Responses") during the Response Time Interval.[7] RFR Responses, which will not be displayed to the market, may be expressed on a net price basis in a multiple of the minimum increment or in one-cent increments, as determined by the appropriate CBOE committee on a class-by-class basis.[8] The legs of a COA-eligible order may be executed in one-

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[4]   See CBOE Rule 6.53C(d).

[5]   The appropriate CBOE committee will determine, on a class-by-class basis, the complex orders that are eligible for a COA based on the order's marketability (defined as a number of ticks away from the current market), size, and complex order type. See CBOE Rule 6.53C(d)(i)(2).

[6]   The RFR message will identify the component series, the size of the COA-eligible order and any contingencies, if applicable, but will not identify the side of the market. See CBOE Rule 6.53C(d)(ii).

[7]   The Response Time Interval is the period of time during which responses to the RFR may be entered. The appropriate CBOE committee will determine the Response Time Interval, which will not exceed three seconds, on a class-by-class basis. See CBOE Rule 6.53C(d)(iii)(2).

[8]   See CBOE Rule 6.53C(d)(iii)(1).

cent increments, regardless of the minimum quoting increments that otherwise would apply to the individual legs of the order.[9]

At the conclusion of the Response Time Interval, a COA-eligible order will trade first based on the best net price(s) available.[10] At the same net price, the COA-eligible order will trade, first, against individual orders and quotes in the EBook, provided the COA-eligible order can be executed in full or in a permissible ratio by orders and quotes in the EBook; second, against public customer complex orders resting in the COB before, or that are received during, the Response Time Interval, and public customer RFR Responses; third, against non-public customer orders resting in the COB before the Response Time Interval; and fourth, against non-public customer orders resting in the COB that are received during the Response Time Interval and non-public customer RFR Responses.[11] A COA-eligible order that cannot be filled in whole or in a permissible ratio will route to the COB or to back to PAR, as applicable.[12]

The COA provisions also address the handling of unrelated complex orders that the CBOE receives prior to the expiration of the Response Time Interval.[13] A pattern or practice of

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[9]   See CBOE Rule 6.53C(d)(v).

[10] See CBOE Rule 6.53C(d)(v).

[11] See CBOE Rule 6.53C(d)(v)(1) - (4).

[12] See CBOE Rule 6.53C(d)(vi).

[13] An incoming COA-eligible order on the opposite side of the market that is marketable against the starting price of the original COA-eligible order will end the original COA; an incoming COA-eligible order on the same side of the market, at the same price or worse than the original COA-eligible order and better than or equal to the starting price, will join the original COA; and an incoming COA-eligible order on the same side of the market at a better price than the original COA-eligible order will join the original COA, cause the original COA to end, and cause a new COA to begin for any remaining balance on the incoming COA-eligible order. See CBOE Rule 6.53C(d)(viii). CBOE Rule 6.53C(d)(viii) also describes the processing of orders when an unrelated complex order arrives prior to the expiration of the Response Time Interval.

submitting orders that cause a COA to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1, "Just and Equitable Principles of Trade."[14] Similarly, the dissemination of information regarding COA-eligible 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 CBOE Rules.[15]

The CBOE states that the COA process may not be used to trade a COA-eligible order against a facilitated or solicited order.[16] In this regard, the CBOE notes that facilitations and solicitations of complex orders, including COA-eligible orders, will continue to be subject to the limitations on facilitations and solicitations provided in Interpretations and Policies .01 and .02 to CBOE Rule 6.45A, "Priority and Allocation of Equity Option Trades on the CBOE Hybrid System," and in Interpretations and Policies .01 and .02 to CBOE Rule 6.45B, "Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System."[17]

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[14]   See CBOE Rule 6.53C, Interpretation and Policy .04.

[15]   See CBOE Rule 6.53C, Interpretation and Policy .05.

[16]   See Notice supra note 3, at 33015 n.12.

[17]   Regarding principal transactions, Interpretation and Policy .01 of CBOE Rules 6.45A and 6.45B prohibit an order entry firm from executing as principal against an order it represents as agent unless: (1) the agency order is first exposed on the Hybrid System for at least three seconds; (2) the order entry firm has been bidding or offering for at least three seconds prior to receiving an agency order that is executable against such bid or offer; or (3) the order entry firm proceeds in accordance with the crossing rules in CBOE Rule 6.74. Regarding solicitation orders, Interpretation and Policy .02 of CBOE Rules 6.45A and 6.45B require an order entry firm to expose for at least three seconds an order it represents as agent before the order may be executed electronically via the electronic execution mechanism of the Hybrid System, in whole or in part, against orders solicited from members and non-member broker-dealers to transact with the order.

B. Revisions to the COB

The CBOE also proposes to revise its rules governing the COB[18] to: (1) allow the appropriate CBOE committee to determine, on a class-by-class basis, whether complex orders routed to or resting in the COB may be expressed on a net price basis in multiples of the minimum increment or in one-cent increments; (2) provide that the legs of a complex order may be executed in one-cent increments, regardless of the minimum quoting increments otherwise applicable to the individual legs of the order; (3) provide that a complex order in the COB may execute against quotes, as well as orders, in the EBook, and that market participants, as defined in CBOE Rule 6.45A or 6.45B, as applicable, may submit quotes, as well as orders, to trade against orders in the COB; (4) provide that the allocation of complex orders within the COB will be pursuant to the rules of trading priority otherwise applicable to incoming orders in the individual component legs; and (5) provide that the allocation of complex orders among market participants will be made pursuant to CBOE Rule 6.45A(c) or 6.45B(c), as applicable.

C. Changes to the Minimum Trading Increment for Complex Orders

CBOE Rule 6.42(3) currently provides that bids and offers in spread, straddle, and combination orders, as defined in CBOE Rule 6.53, may be expressed in any increment, regardless of the minimum increments otherwise appropriate to the individual legs of the order. The proposal revises CBOE Rule 6.42(3) to include the other complex orders defined in CBOE Rule 6.53C in addition to the complex orders currently enumerated CBOE Rule 6.42(3).[19]

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18   See CBOE Rule 6.53C(c).

19   The complex orders defined in CBOE Rule 6.53C(a) are: spread order; straddle order; strangle order; combination order as defined in CBOE Rule 6.53(e); ratio order; butterfly spread order; box/roll spread order; collar orders and risk reversals; and conversions and reversals.

CBOE Rule 6.42(3) also provides that bids and offers for spread, straddle, or combination orders in S&P 500 Index options, other than box spreads, must be expressed in decimal increments no smaller than $.05. The CBOE proposes to apply this provision to S&P 100 Index options. The CBOE believes that this change is appropriate in light of the complexity of complex orders and the size of the underlying S&P 100 Index.

In addition, the proposal revises CBOE Rule 6.42(3) to state that the legs of complex orders may be executed in one-cent increments. CBOE Rule 6.42(3) will continue to require complex orders to be expressed in net price increments that are multiples of the minimum increment to be entitled to priority under CBOE Rule 6.45, "Priority of Bids and Offers-- Allocation of Trades."

    D.   <u>Additional Changes</u>

The CBOE proposes to revise CBOE Rules 6.45; 6.45A; 6.45B; Interpretation and Policy .03 to CBOE Rule 6.74, "Crossing Orders;" and CBOE Rule 6.9, "Solicited Transactions," to include the complex orders defined in CBOE Rule 6.53C in addition to the complex orders currently specified in the rules.

III.   <u>Discussion</u>

After careful review, 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 and, in particular, with Section 6(b)(5) of the Act,[20] which requires, among other things, 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

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[20]   15 U.S.C. 78f(b)(5).

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.[21]

The new COA functionality will provide an electronic auction for eligible complex orders. Under the COA auction process, Market Makers with an appointment in the relevant options class and members acting as agent for orders resting at the top of the COB in the relevant options series will be able to submit RFR Responses. At the conclusion of the COA auction, the auctioned order will execute against the interest available in the EBook, the COB, and/or RFR Responses submitted during the COA.[22] By providing an electronic auction for eligible complex orders, the Commission believes that the COA process could facilitate the execution of eligible complex orders and provide them with an opportunity for price improvement.

The Commission notes that the CBOE's rules provide that a pattern or practice of submitting orders that cause a COA to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1,[23] and that the dissemination of information regarding COA-eligible 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 CBOE rules.[24] These provisions will require the CBOE to surveil for, and should help to deter, potential abuses of the COA process.

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[21] 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).

[22] See notes 10-12, supra, and accompanying text. The Commission notes that, at the same price, public customer orders in the COB and public customer RFR Responses will trade against a COA-eligible order before non-public customer orders in the COB and non-public customer RFR Responses. See CBOE Rule 6.53C(d)(v)(2) - (4).

[23] See CBOE Rule 6.53C, Interpretation and Policy .04.

[24] See CBOE Rule 6.53C, Interpretation and Policy .05.

In addition, the Commission notes that the COA system cannot be used to trade a COA-eligible order against a facilitated or solicited order. COA-eligible orders, like other orders on the Hybrid System, will be subject to CBOE Rule 6.45A, Interpretation and Policies .01 and .02, and CBOE Rule 6.45B, Interpretation and Policies .01 and .02. Accordingly, a CBOE member seeking to trade with its customer's COA-eligible order would be required to comply with Interpretation and Policy .01 of CBOE Rule 6.45A or 6.45B, as applicable, and a CBOE member seeking to cross its customer's COA-eligible order with a solicited order would be required to comply with Interpretation and Policy .02 of CBOE Rule 6.45A or 6.45B, as applicable.

The Commission believes that the changes to the COB should facilitate the execution of complex orders. In this regard, the proposal revises CBOE Rule 6.53C(c) to provide that quotes in the EBook, as well as orders in the EBook, may execute against a complex order in the COB, and that market participants, as defined in CBOE Rule 6.45A or 6.45B, as applicable, may submit quotes, as well as orders, to trade against orders in the COB. In addition, the proposal revises CBOE Rule 6.53C(c) to allow complex orders routed to or resting in the COB to be expressed and executed in one-cent increments, thereby providing additional price points at which complex orders could be executed.[25] The proposal also clarifies the operation of the COB by providing that complex orders in the COB will be allocated pursuant to the rules of trading priority otherwise applicable to incoming electronic orders in the individual component legs,[26]

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[25] The appropriate CBOE committee will determine, on a class-by-class basis, whether complex orders routed to or resting in the COB may be expressed in a multiple of the minimum increment or in one-cent increments. See CBOE Rule 6.53C(c)(ii).

[26] See CBOE Rule 6.53C(c)(ii)(2).

and that complex orders will be allocated among market participants pursuant to CBOE Rule

6.45A or 6.45B, as applicable.[27]

The CBOE proposes to revise CBOE Rule 6.42(3) to allow the legs of a complex order to

be executed in one-cent increments, which, according to the CBOE, will allow members to

execute complex order transactions more easily. Accordingly, the Commission believes that this

change could facilitate the execution of complex orders. The Commission notes that CBOE Rule

6.42(3) will continue to require complex orders to be expressed in multiples of the minimum

increment to be entitled to priority under CBOE Rule 6.45.

CBOE Rule 6.42(3) currently requires bids and offers in complex orders in S&P 500

Index options, other than box spreads, to be expressed in increments no smaller than $0.05. The

CBOE proposes to apply this provision to S&P 100 Index options. The Commission believes

that this change is consistent with the Act because of the similarities between the S&P 500 Index

and the S&P 100 Index.

Finally, the Commission believes that the proposal to revise CBOE Rules 6.45, 6.45A,

6.45B, 6.9, and 7.4 to include the complex orders defined in CBOE Rule 6.53C is consistent with

the Act because it should provide consistent treatment for different types of complex orders

under the CBOE's rules.

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[27]   See CBOE Rule 6.53C(c)(ii)(3).

IV.   Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[28] that the

proposed rule change (SR-CBOE-2005-65), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated

authority.[29]

Nancy M. Morris
Secretary

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[28]   15 U.S.C. 78s(b)(2).

[29]   17 CFR 200.30-3(a)(12).