SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55154; File No. SR-CBOE-2006-92)

January 23, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting
Approval to Proposed Rule Change as Modified by Amendment No. 1 Thereto, Relating to the
Penny Pilot Program

I.   Introduction

On November 8, 2006, 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 amend its rules to permit certain option classes to be quoted in pennies

on a pilot basis. The proposed rule change was published for comment in the Federal Register

on November 29, 2006.[3] The Commission received one comment letter on the proposed rule

change.[4] On January 9, 2007, the Exchange filed Amendment No. 1 to the proposed rule

change.[5] The Exchange responded to the comment letter on January 10, 2007.[6] This order

approves the proposed rule change as modified by Amendment No. 1.

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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. 54805 (November 21, 2006), 71 FR 69151.

[4]   See letter to Nancy M. Morris, Secretary, Commission, from Christopher Nagy, Chair,
        Securities Industry and Financial Markets Association ("SIFMA") Options Committee,
        dated December 20, 2006 ("SIFMA Letter").

[5]   Amendment No. 1 revised the Regulatory Circular CBOE will distribute to its members
        to reflect the replacement of Glamis Gold, which was delisted, with Agilent Tech, Inc. in
        the list of options classes permitted to be quoted in pennies. Amendment No. 1 is
        technical in nature, and the Commission is not publishing Amendment No. 1 for public
        comment.

[6]   See letter to Nancy M. Morris, Secretary, Commission, from Patrick Sexton, Associate
        General Counsel, CBOE, dated January 10, 2007 ("CBOE Letter").

II.   Description of the Proposal

        A.   Scope of the Penny Pilot Program

CBOE proposes to amend its rules to permit certain option classes to be quoted in

pennies during a six-month pilot ("Penny Pilot Program"), which would commence on January

26, 2007. Specifically, proposed CBOE Rule 6.42 would include a subparagraph stating that

decimal increments for bids and offers for all series of option classes participating in the Penny

Pilot Program will be announced by Regulatory Circular. The Regulatory Circular would set

forth the parameters of the Penny Pilot Program.

        Currently, all six options exchanges, including CBOE, quote options in nickel and dime

increments. The minimum price variation for quotations in options series that are quoted at less

than $3 per contract is $0.05 and the minimum price variation for quotations in options series

that are quoted at $3 per contract or greater is $0.10. Under the Penny Pilot Program, beginning

on January 26, 2007, market participants would be able to begin quoting in penny increments in

certain series of option classes.

        The Penny Pilot Program would include the following thirteen options: Ishares Russell

2000 (IWM); NASDAQ-100 Index Tracking Stock (QQQQ); SemiConductor Holders Trust

(SMH); General Electric Company (GE); Advanced Micro Devices, Inc. (AMD), (Microsoft

Corporation (MSFT); Intel Corporation (INTC); Caterpillar, Inc. (CAT); Whole Foods Market,

Inc. (WFMI); Texas Instruments, Inc. (TXN); Flextronics International Ltd. (FLEX); Sun

Microsystems, Inc. (SUNW); and Agilent Tech, Inc. (A). The Exchange would communicate the

list of options to be included in the Penny Pilot Program to its membership via Regulatory Circular.

The minimum price variation for all classes included in the Penny Pilot Program, except for the QQQQs, would be $0.01 for all quotations in option series that are quoted at less than $3 per contract and $0.05 for all quotations in option series that are quoted at $3 per contract or greater. The QQQQs would be quoted in $0.01 increments for all options series.

CBOE commits to deliver a report to the Commission during the fourth month of the pilot, which would be composed of data from the first three months of trading. The report would analyze the impact of penny pricing on market quality and options systems capacity.

CBOE also proposes to amend CBOE Rule 6.54 relating to accommodation liquidations ("cabinet trades") to state that the rule is not applicable to trading in option classes participating in the Penny Pilot Program. Currently, CBOE Rule 6.54 sets forth the terms and conditions in which cabinet trades can be executed on CBOE. Because cabinet trades involve orders priced at $1 per option contract, the specific terms and conditions for cabinet trading are not applicable to option classes participating in the Penny Pilot Program.

B.   Quote Mitigation Strategies

To mitigate quote message traffic, CBOE has represented to the Commission that it has already implemented or intends to implement the following quote mitigation strategies.

- Limitation on Messages. Pursuant to CBOE Rule 6.23A, CBOE currently limits the number of messages sent by members accessing CBOE electronically in order to protect the integrity of the Hybrid Trading System. Limiting the number of messages sent by members accessing CBOE electronically reduces the number of quotations sent by CBOE to the Options Price Reporting Authority ("OPRA").

- Amendment to Market-Maker Obligations. CBOE proposes to amend CBOE Rule 8.7 to modify the continuous electronic quoting obligation of Market-Makers and Remote Market-Makers ("RMMs"). Currently, as set forth in CBOE Rule 8.7(d)(ii) and (e), Market-Makers and RMMs, respectively, are obligated to provide continuous electronic quotes in 60% of the series of his/her appointed option class. CBOE proposes to amend these obligations to provide that Market-Makers and RMMs shall provide continuous electronic quotes in 60% of the series of his/her appointed class that have a time to expiration of less than nine months. CBOE believes that excluding series that are nine months or more to expiration, i.e., LEAPS, from Market-Makers' and RMMs' continuous quoting obligations should reduce the number of quotes CBOE disseminates to OPRA, while continuing to impose upon Market-Makers and RMMs significant quoting obligations. CBOE also notes that this proposed change is consistent with CBOE Rule 5.8 which provides that the continuity rules do not apply to option series until the time to expiration is less than nine months.[7]

- Delisting Policy. CBOE is adopting the following delisting policy: equity option classes with national average daily volume ("ADV") of less than 20 contracts will be delisted.

- Oversight of Member Quoting. CBOE continuously monitors the quotation activity of its members submitting electronic quotations to CBOE, and regularly notifies any member that appears to be disseminating significantly more quotations than other members. CBOE also regularly communicates with independent vendors who provide quotation services to members to encourage the vendors to modify their systems to

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[7]   The Commission recently approved a similar proposal from the Philadelphia Stock Exchange. See Securities Exchange Act Release No. 54648 (October 24, 2006), 71 FR 63375 (October 30, 2006) (SR-Phlx-2006-52).

provide efficient quotation systems and to alert them whenever it appears that users of

their system appear to be submitting significantly more quotations than other members.[8]

III.   Discussion

After careful review of the proposal and consideration of SIFMA's comment letter and

the Exchange's response thereto, the Commission finds that the proposed rule change, as

modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and

regulations thereunder applicable to a national securities exchange.[9] In particular, the

Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[10] which

requires, among other things, that the rules of an exchange be designed 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 Commission believes that the implementation of a limited six-month Penny Pilot

Program by CBOE and the five other options exchanges will provide valuable information to the

exchanges, the Commission and others about the impact of penny quoting in the options market.

In particular, the Penny Pilot Program will allow analysis of the impact of penny quoting on: (1)

spreads; (2) transaction costs; (3) payment for order flow; and (4) quote message traffic.

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[8]   In addition to the quote mitigation strategies discussed above, to encourage more efficient
        quoting by its members, the Exchange filed a proposed rule change on November 20,
        2006, that assesses an additional monthly fee, commencing on February 1, 2007, on all
        Market Makers who submit electronic quotes to the Exchange of $.03 per 1,000 quotes in
        excess of 1,000,000 quotes. The proposed rule change was immediately effective under
        Section 19(b)(3)(A) of the Act. See Securities Exchange Act Release No. 54804
        (November 21, 2006), 71 FR 69150 (November 29, 2006) (File No. SR-CBOE-2006-98).

[9]   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).

[10]   15 U.S.C. 78f(b)(5).

The Commission believes that the thirteen options classes to be included in the penny pilot program represent a diverse group of options classes with varied trading characteristics. This diversity should facilitate analyses by the Commission, the options exchanges and others. The Commission also believes that the Penny Pilot Program is sufficiently limited that it is unlikely to increase quote message traffic beyond the capacity of market participants' systems and disrupt the timely receipt of quote information.

Nevertheless, because the Commission expects that the Penny Pilot Program will increase quote message traffic, the Commission is also approving the Exchange's proposals to reduce the number of quotations it disseminates.

SIFMA commented on the CBOE's quote mitigation proposal.[11] SIFMA recommends that all six of the option exchanges adopt a comprehensive and uniform quote mitigation strategy. In particular, SIFMA strongly supports the adoption of the "holdback timer" mitigation proposal as the most efficient means of reducing quotation traffic. SIFMA, however, expressed concern that the lack of uniformity among the quote mitigation proposals adopted by the exchanges will impose a burden on member firms and cause confusion for market participants, especially retail investors.

Although SIFMA urges the adoption of a uniform and comprehensive approach to quote mitigation, it does not oppose CBOE's quote mitigation proposals. In fact, SIFMA acknowledges that certain of CBOE's proposals, such as notifying members whose quote activity suggests systems malfunctions or wrong settings and delisting inactive series can contribute to quote mitigation. SIFMA, however, expressed its belief that these proposals do not go far enough to resolve the industry's concerns regarding systems capacity.

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[11]   See SIFMA Letter, supra note 4.

Although the Commission supports efforts to implement a uniform, industry-wide quote mitigation plan, it does not believe such efforts preclude individual exchanges from initiating their own quote mitigation strategies. The Commission agrees with CBOE that its proposed quote mitigation strategies will not lead to confusion among market participants.[12]

IV.   Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[13] that the proposed rule change (SR-CBOE-2006-92), as modified by Amendment No. 1, be, and hereby is, approved on a six month pilot basis, which will commence on January 26, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[14]

Florence E. Harmon
Deputy Secretary

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[12]   See CBOE Letter, supra note 6.

[13]   15 U.S.C. 78s(b)(2).

[14]   17 CFR 200.30-3(a)(12).