SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61259; File No. SR-CBOE-2009-025)

December 30, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Related to the Simple Auction Liaison (SAL)

I. Introduction

On May 4, 2009, 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 CBOE Rule 6.13A to revise the Designated Primary Market-Maker ("DPM")/Lead Market-Maker ("LMM") participation entitlement formula that is applicable to Simple Auction Liaison ("SAL") executions in Hybrid 3.0 classes on a one-year pilot basis. On November 13, 2009, CBOE filed Amendment No. 1 to the proposed rule change, which replaced the original filing in its entirety. The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on November 24, 2009.[3] The Commission received no comment letters on the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal

CBOE Rule 6.13A governs the operation of the Exchange's SAL system. SAL is a feature within CBOE's Hybrid System that auctions marketable orders for price improvement over the national best bid or offer ("NBBO"). For Hybrid 3.0 Classes in which SAL is

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

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 61024 (November 18, 2009), 74 FR 61395.

activated,[4] the Exchange determines, on a class-by-class basis, which electronic matching algorithm from CBOE Rule 6.45B shall apply to SAL executions (e.g., pro-rata, price-time, UMA priority with public customer, participation entitlement and/or market turner priority overlays).[5]

The Exchange also may establish, on a class-by-class basis, a DPM/LMM participation entitlement that is applicable only to SAL executions.[6] Pursuant to CBOE Rules 8.15B and 8.87, the participation entitlement generally is 50% when there is one other Market-Maker also quoting at the best bid/offer on the Exchange, 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange, and 30% when there are three or more Market-Makers also quoting at the best bid/offer on the Exchange. In addition, the participation entitlement must be in compliance with Rule 6.45B(a)(i)(2).[7] In relevant part, Rule 6.45B(a)(i)(2) provides that the DPM or LMM may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price.[8] Further, if pro-rata priority is in effect and the DPM or LMM's allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted (the "pro-rata share"), the DPM or LMM shall not receive any further allocation of that order.[9] The rule also provides that the participation entitlement shall not be in effect unless public customer priority is in effect in a

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4 Currently, SPX (options on the S&P 500 Index) is the only Hybrid 3.0 class. Telephone call between Angelo Evangelou, Assistant General Counsel, CBOE, and Sara Hawkins, Special Counsel, Division of Trading and Markets, Commission, on December 14, 2009.

5 See CBOE Rule 6.13A, Interpretation .04(ii).

6 Id.

7 Id.

8 See CBOE Rule 6.45B(a)(i)(2)(B).

9 Id.

priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance.[10] In addition, responses to SAL auctions are capped to the size of the Agency Order for allocation purposes pursuant to Rule 6.13A.[11]

The Exchange is now proposing to modify the DPM/LMM entitlement when the pro-rata algorithm is in effect for SAL in selected Hybrid 3.0 classes as part of a pilot program that will operate on a one-year basis. For such pro-rata classes, after all public customer orders in the book at the best bid/offer and the DPM/LMM participation entitlement have been satisfied, the DPM/LMM shall be eligible to participate in any remaining balance on a pro-rata basis (regardless of whether its participation entitlement is greater than its pro-rata share).[12]

As part of the pilot program, on a quarterly basis the Exchange will evaluate the number of SAL executions in each pilot class where the DPM/LMM participation entitlement was applied and the allocation was greater than what it would have been under the pre-pilot allocation algorithm. The Exchange will reduce the DPM/LMM participation entitlement for the class if the number of SAL executions that exceeded the benchmark is more than 1% of the total number of SAL executions in the class evaluated during the quarter. This evaluation will be based on a random sampling of three days for each month in each quarter. The "benchmark" will be 60% where there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% where there are two Market-Makers also quoting at the best bid/offer on the Exchange; and

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10 See CBOE Rule 6.45B(a)(i)(2)(D). CBOE Rule 6.45B(a)(i)(2) also provides that, to be entitled to their participation entitlement, the DPM/LMM's order and/or quote must be at the best price on the Exchange. For purposes of SAL executions, the Exchange noted that it interprets this to mean that the DPM/LMM must be at the best price at both the start and the conclusion of the SAL auction.

11 See Notice, supra note 3, for an example of an allocation of a SAL order.

12 See Notice, supra note 3, for an example of an allocation of a SAL order under the proposed rule change.

40% where there are three or more Market-Makers also quoting at the best bid/offer on the Exchange. The benchmark percentages, which in some instances are greater than CBOE's DPM/LMM participation entitlement percentages contained in Rules 8.15B and 8.87, are based on the market-maker participation entitlement percentages that are available on other options exchanges.[13] During the pilot, the Exchange will submit a quarterly report containing certain data related to this evaluation to the Commission.[14]

III. Discussion and Findings

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.[15] Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[16] which requires, among other things, that the rules of a national securities 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 has closely scrutinized proposals which would provide participation entitlements to specialists or market makers or would increase any such existing entitlements.[17]

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13 See, e.g., International Securities Exchange Rule 7.13.01(b) (provides a 60% participation right if there is only one other Professional Order or market maker quotation at the best price) and NYSE Arca, Inc. Rule 6.76A(a)(1)(A)(i) (provides a 40% participation right regardless of the number of other market participants at the best price).

14 See Notice, supra note 3, for further detail on the data to be provided in the reports submitted to the Commission. Such data will be provided by CBOE on a confidential basis.

15 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).

16 15 U.S.C. 78f(b)(5).

17 See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (establishing trading rules for the Boston Options Exchange Facility)

The Commission has recognized that such entitlements to specialists, market makers, or other members that "lock up" a certain portion of each affected order reduce the number of contracts for which other members and market participants can compete.[18] Eventually, if particular exchange members "lock up" a large share of customer orders, competing members would have less incentive to compete by offering better prices on an exchange and competition could diminish. As a result, the disseminated quotations, and the other trading interest available on a market, could deteriorate, ultimately harming investors.[19]

As noted, CBOE's proposal will permit DPMs and LMMs to execute a larger share of a SAL order than under the current allocation algorithm, as DPMs and LMMs will now be permitted to receive their DPM/LMM participation entitlement as well as a pro-rata share of the remaining balance on an order (after all public customer orders in the book at the best bid/offer and the DPM/LMM participation entitlement have been satisfied). However, the Commission believes that any potential concerns regarding the increased allocation to DPMs/LMMs, as discussed above, are mitigated by the terms and conditions of the pilot program. Specifically, during the pilot program, the Exchange will be required to closely monitor a random sampling of the SAL executions and evaluate executions in which the DPM/LMM allocation is greater than what it would have been under the previous allocation algorithm. These SAL executions will be evaluated against a "benchmark" that is based on market-maker participation entitlement

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and Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11395 (March 2, 2000) (order approving the registration of the International Securities Exchange LLC as a national securities exchange).

18 Id.

19 Id.

percentages that have been approved by the Commission for other options exchanges.[20] If the number of SAL executions that exceeds the benchmark amounts to more than 1% of the total number of SAL executions in the class evaluated during the quarter, the Exchange must reduce the DPM/LMM participation entitlement for that class. As such, the Commission believes that the proposal will permit only DPM/LMM allocations that are generally consistent with the level of participation entitlement that the Commission has previously approved for other options exchanges.

Further, the Exchange will submit quarterly reports to the Commission providing data on SAL executions evaluated during the relevant time period. In evaluating the pilot program, the Commission will consider, among other things, how often the allocation percentage exceeds the benchmark and by what amount. The Commission will closely scrutinize the pilot program to ensure that the DPM/LMM allocations under the proposed rule change are generally in line with the maximum participation entitlement percentages that the Commission has previously approved.

For these reasons, the Commission finds that the proposed rule change is consistent with the Act.

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20 See supra note 13. Specifically, the "benchmark" will be 60% where there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% where there are two Market-Makers also quoting at the best bid/offer on the Exchange; and 40% where there are three or more Market-Makers also quoting at the best bid/offer on the Exchange.

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[21] that the proposed rule change (SR-CBOE-2009-025), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[22]

Florence E. Harmon
Deputy Secretary

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21 15 U.S.C. 78s(b)(2).

22 17 CFR 200.30-3(a)(12).