SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64653; File No. SR-CBOE-2011-041)

June 13, 2011

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval of Proposed Rule Change Establishing Qualified Contingent Cross Orders

I. Introduction

On April 18, 2011, the Chicago Board Options Exchange, Inc. ("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 establish qualified contingent cross orders ("QCC Order"). The proposed rule change was published in the Federal Register on May 4, 2011.[3] The Commission received four comments on the proposal.[4] CBOE submitted a comment response letter on June 6, 2011.[5] This order grants approval of the proposed rule change.

II. Description of the Proposal

CBOE proposes to amend CBOE Rule 6.53 to adopt rules related to a new QCC Order type that will be available to CBOE Trading Permit Holders ("TPHs").[6] CBOE Rule 6.53 would

---

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 64354 (April 27, 2011), 76 FR 25392 ("Notice").

4 See Letters to Elizabeth M. Murphy, Secretary, Commission, from Martin Galivan, dated May 4, 2011("Galivan Letter"); Ron March, dated May 4, 2011 ("March Letter"); Jesse L. Stamer, dated May 8, 2011 ("Stamer Letter"); and Michael J. Simon, Secretary, International Securities Exchange ("ISE"), dated May 27, 2011 ("ISE Letter").

5 See Letter to Elizabeth M. Murphy, Secretary, Commission, from Jennifer M. Lamie, Assistant General Counsel, CBOE, dated June 6, 2011 ("CBOE Response Letter").

6 In the Notice, the Exchange states that the proposal will permit CBOE to remain competitive with ISE, which has a QCC Order type that is submitted from off the floor,

permit QCC Orders to be submitted electronically from either on or off the floor through the CBOE Hybrid Trading System. The QCC Order would permit a TPH to cross the options leg(s) of a qualified contingent trade ("QCT")[7] in a Regulation NMS stock, on CBOE immediately without exposure if the order is: (i) for at least 1,000 contracts; (ii) is part of a QCT;[8] (iii) is executed at a price at least equal to the national best bid or offer ("NBBO"); and (iv) there are no public customer orders resting in the Exchange's electronic book at the same price. Specifically, the QCC Order type would permit TPHs to provide their customers a net price for the stock-option trade, and then allow the TPH to execute the options leg(s) of the trade on CBOE at a price at least equal to the NBBO while using the QCT exemption to effect the trade in the

---

and other options exchanges that may adopt a similar order type. See Notice, supra note 3, at 25393.

7 The Commission has granted an exemption for QCTs that meet certain requirements from Rule 611(a) of Regulation NMS, 17 CFR 242.611(a). See Securities Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) ("QCT Release," which supersedes a release initially granting the QCT exemption, Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) ("Original QCT Release")).

8 CBOE is proposing to define a qualified contingent cross trade substantively identical to the Commission's definition in the QCT Release. A qualified contingent cross trade must meet the following conditions: (i) at least one component must be an NMS stock, as defined in Rule 600 of Regulation NMS, 17 CFR 242.600; (ii) all components must be effected with a product or price contingency that either has been agreed to by all the respective counterparties or arranged for by a broker-dealer as principal or agent; (iii) the execution of one component must be contingent upon the execution of all other components at or near the same time; (iv) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined by the time the contingent order is placed; (v) the component orders must bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or cancelled; and (vi) the transaction must be fully hedged (without regard to any prior existing position) as a result of other components of the contingent trade. Consistent with the QCT Release, TPHs would be required to demonstrate that the transaction is fully hedged using reasonable risk-valuation methodologies. See QCT Release, supra note 7, at footnote 9.

equities leg at a price necessary to achieve the net price.[9] The Exchange would not permit the options component(s) of a QCC Order to trade through the NBBO.

III. Comment Letters

Four commenters raised objections to the proposal.[10] One commenter expressed the concern that the QCC Order would prohibit potential price improvement because such order may trade on the Exchange immediately without exposure.[11] The commenter was also concerned that the proposal may promote internalization of order flow to the benefit of a few select firms.[12] Another commenter stated that the proposal may decrease liquidity in the market and was concerned that public customer orders may get traded through.[13] Further, a commenter suggested that the proposal would create an uneven playing field in the market to the benefit of large institutional customers and detriment of small individual investors.

Another commenter questioned the ability of a floor-based exchange to verify that there is not a customer order on the book at the price as a QCC order at the time of execution.[14] The commenter argued that in an electronic trading environment, an exchange's systems can automatically determine if there is a customer order on the book before a QCC order is

---

9 CBOE represented that it will adopt policies and procedures to ensure that TPHs use the QCC Order properly and require TPHs to properly mark all QCC Orders as such. Additionally, CBOE will implement an examination and surveillance program to assess TPH compliance with the requirements applicable to QCC Orders, including the requirement that the stock leg of the transaction be executed at or near the same time as the options leg.

10 See note 4, supra.

11 See Galivan Letter.

12 See Galivan Letter.

13 See Stamer Letter.

14 See ISE Letter.

executed.[15] The commenter stated that how this function would be performed on a floor-based exchange should be clarified, as well as what the time of execution would be for a floor-based trade.[16] The commenter argued that "[a]llowing a QCC to be implemented in a non-automated environment without a systemic check of whether there is a customer order on the book at the time of execution would effectively eliminate the protections guaranteed in an all electronic trading environment, thus returning [the exchanges] to the unequal competitive environment from which the ISE's QCC proposal originated."[17]

In its letter, CBOE responded to the issues raised in the ISE Letter and explained that, even when QCC Orders are submitted for execution from the floor, they are submitted electronically and that these orders would not be represented in "open outcry."[18] CBOE also clarified that the time of execution of a QCC Order would not vary depending on whether the order is submitted from on the floor or off the floor and that the execution would occur when the QCC Order is submitted to the CBOE Hybrid Trading System.[19]

IV. Discussion and Commission's Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and finds that it is consistent with the requirements of Section 6(b) of the Act.[20] Specifically, the Commission finds that the proposal is consistent with Sections 6(b)(5)[21] and 6(b)(8),[22] which

---

15 Id.

16 Id.

17 Id.

18 See CBOE Response Letter, supra note 5.

19 Id.

20 15 U.S.C. 78f(b). 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).

21 15 U.S.C. 78f(b)(5).

require, 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 and that the rules of an exchange do no impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In addition, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,[23] in which Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things, the economically efficient execution of securities transactions.

The Commission believes that the proposed rule change, which would permit a clean cross of the options leg of a subset of qualified contingent trades, is appropriate and consistent with the Act.[24] The Commission believes that this order type may facilitate the execution of qualified contingent trades, which the Commission found to be beneficial to the market as a whole by contributing to the efficient functioning of the securities markets and the price discovery process.[25] The QCC Order would provide assurance to parties to stock-option qualified contingent trades that their hedge would be maintained by allowing the options component to be executed as a clean cross.

While the Commission believes that order exposure is generally beneficial to options markets in that it provides an incentive to options market maker to provide liquidity and therefore plays an important role in ensure competition and price discovery in the options

---

22 15 U.S.C. 78f(b)(8).

23 15 U.S.C. 78k-1(a)(1)(C).

24 See also Securities Exchange Act Release No. 63955 (February 24, 2011), 76 FR 11533 (March 2, 2011) (SR-ISE-2010-73) (“ISE QCC Approval”).

25 See Original QCT Release, supra note 7.

markets, it also has recognized that contingent trades can be "useful trading tools for investors and other market participants, particularly those who trade the securities of issuers involved in mergers, different classes of shares of the same issuers, convertible securities, and equity derivatives such as options [italics added],"[26] and that "[t]hose who engage in contingent trades can benefit the market as a whole by studying the relationships between prices of such securities and executing contingent trades when they believe such relationships are out of line with what they believe to be fair value."[27] As such, the Commission stated that the transactions that meet the specified requirements of the NMS QCT Exemption could be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.[28]

Thus, in light of the benefits provided by both the requirement for exposure as well as by qualified contingent trades such as QCC Orders, the Commission must weigh the relative merits of both for the options markets.[29] The Commission believes that the proposal, in requiring a QCC Order be: (1) part of a qualified contingent trade under Regulation NMS; (2) for at least 1,000 contracts; (3) executed at a price at or between the NBBO; and (4) cancelled if there is a public customer on the electronic book, strikes an appropriate balance for the options market in that it is narrowly drawn and establishes a limited exception to the general principle of exposure and retains the general principle of customer priority in the options markets. Furthermore, not only must a QCC Order be part of a qualified contingent trade by satisfying each of the six

---

26 See id. at 52830-52831.

27 Id.

28 See QCT Release, supra note 7 at 19273.

29 The Commission notes that it has previously permitted the crossing of two public customer orders, for which no exposure is required on ISE and CBOE. See CBOE Rule 6.74A.09 and ISE Rule 715(i) and 721.

underlying requirements of the NMS QCT Exemption, the requirement that a QCC Order be for a minimum size of 1,000 contracts provides another limit to its use by ensuring only transactions of significant size may avail themselves of this order type.[30]

The Commission notes that, under CBOE's proposal, QCC Orders may be submitted electronically from either on or off the floor through the CBOE Hybrid Trading System. CBOE has represented that to effect proprietary orders, including QCC Orders, electronically from on the floor of the Exchange, members must qualify for an exemption from Section 11(a)(1) of the Act,[31] which concerns proprietary trading on an exchange by an exchange member. Among other exemptions, common exemptions include: an exemption for transactions by broker dealers acting in the capacity of a market maker under Section 11(a)(1)(A);[32] the "G" exemption for yielding priority to non-members under Section 11(a)(1)(G) of the Act and Rule 11a1-1(T) thereunder;[33] and the "effect vs. execute" exemption under Rule 11a2-2(T) under the Act.[34] The Exchange recognized in its filing that, consistent with existing Exchange rules for effecting proprietary orders from on the floor of the Exchange, TPHs effecting QCC Orders and relying on

---

30 The Commission notes that the requirement that clean crosses be of a certain minimum size is not unique to the QCC Order. See, e.g., NSX 11.12(d), which requires, among other things, that a Clean Cross be for at least 5,000 shares and have an aggregate value of at least $100,000.

31 15 U.S.C. 78k(a)(1). Generally, Section 11(a)(1) of the Act restricts any member of a national securities exchange from effecting any transaction on such exchange for: (i) the member's own account, (ii) the account of a person associated with the member, or (iii) an account over which the member or a person associated with the member exercises discretion, unless a specific exemption is available.

32 15 U.S.C. 78k(a)(1)(A).

33 15 U.S.C. 78k(a)(1)(G) and 17 CFR 240.11a1-1(T).

34 17 CFR 240.11a2-2(T).

the "G" exemption would be required to yield priority to any interest, not just public customer orders, in the electronic book at the same price to ensure that non-member interest is protected.[35]

In approving a similar order type for ISE, the Commission considered the issues raised in the Galivan Letter, March Letter, and Stamer Letter, and found that ISE's QCC order type was consistent with the requirements of the Act and the rules and regulations thereunder.[36] In addition, the Commission believes that CBOE's response letter clarified the questions raised by ISE in the ISE Letter.

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with Section 6(b)(5)[37] and 6(b)(8)[38] of the Act. Further, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act.[39]

---

35 See, e.g., Securities Exchange Act Release No. 59546 (March 10, 2009), 74 FR 11144 (March 16, 2009) (SR-CBOE-2009-016) and CBOE Regulatory Circular RG09-35 (providing guidance on the application of Section 11(a)(1) and certain of the exemptions, as well as the application of the "G" exemption and the Effect vs. Execute exemption to trading on the Hybrid Trading System).

36 See ISE QCC Approval, supra note 24.

37 15 U.S.C. 78f(b)(5).

38 15 U.S.C. 78f(b)(8).

39 15 U.S.C. 78k-1(a)(1)(C).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[40] that the proposed rule change (SR-CBOE-2011-041) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[41]

Cathy H. Ahn
Deputy Secretary

---

40 15 U.S.C. 78s(b)(2).

41 17 CFR 200.30-3(a)(12).