

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66235; File No. SR-CBOE-2011-114)

January 25, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change Relating to Complex Order Processing in Hybrid 3.0 Classes

I. Introduction

On November 29, 2011, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to revise the rules governing the execution of complex orders in options classes trading on CBOE’s Hybrid 3.0 trading platform. The proposed rule change was published for comment in the Federal Register on December 14, 2011.<sup>3</sup> The Commission received no comments regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposal

CBOE proposes to add new Interpretation and Policy .10 to CBOE Rule 6.53C, “Complex Orders on the Hybrid System,” to revise the operation of the complex order book (“COB”) and the complex order request for responses auction process (“COA”) for complex orders in options classes traded on CBOE’s Hybrid 3.0 trading platform. The Hybrid 3.0 platform is an electronic trading platform that allows one or more quoters to submit electronic quotes that represent the aggregate market maker quoting interest in a series for the trading crowd. Certain designated Lead Market Makers currently generate the aggregate trading crowd

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 65914 (December 8, 2011), 76 FR 77878.

quote. S&P 500 Index options (“SPX”) are the only options that currently trade on the Hybrid 3.0 trading platform.

Currently, complex orders submitted to COB or COA may execute automatically against (i) individual orders and quotes residing in the CBOE’s electronic book (“EBook”), provided that the complex order can be executed in full or in a permissible ratio; and (ii) against other complex orders represented in COB or COA, as applicable.<sup>4</sup>

New CBOE Rule 6.53C, Interpretation and Policy .10 provides that, for Hybrid 3.0 classes, CBOE may determine not to allow marketable complex orders entered into COB and/or COA to execute automatically against individual quotes residing in the EBook. A marketable complex order would be able to execute automatically against other complex orders or against individual orders in the EBook, provided that conditions in CBOE Rule 6.53C, Interpretation and Policy .10 are satisfied. In particular, a marketable complex order will execute automatically against individual orders in the EBook, provided that the complex order can be executed in full, or in a permissible ratio, against the individual orders in the EBook and the individual orders in the EBook are priced equal to, or better than, the quotes residing in the EBook.<sup>5</sup> Complex orders that are marketable against each other will execute automatically, provided that the execution is at a net price that has priority over the individual orders and quotes in the EBook.<sup>6</sup>

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<sup>4</sup> See CBOE Rules 6.53C(c), “Complex Order Book,” and 6.53C(d), “Process for Complex Order RFR Auction.”

<sup>5</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(a).

<sup>6</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(b).

The allocation of marketable complex orders against individual orders in the EBook and against other complex orders will be based on the best net price(s).<sup>7</sup> At the same net price, multiple orders will be allocated as provided in CBOE Rule 6.53C(c) and/or (d), as applicable.<sup>8</sup>

To the extent that a marketable complex order cannot execute automatically in full or in a permissible ratio when it is routed to COB or after being subject to a COA, any part of the order that may be executed will be executed automatically and the part of the order that cannot execute automatically will route to PAR or, at the order entry firm's discretion, to the order entry firm's booth.<sup>9</sup> If an order is not eligible to route to PAR, the remaining balance will be cancelled.<sup>10</sup>

In addition, to the extent that a complex order resting in COB becomes marketable and cannot execute automatically in full or in a permissible ratio, the full order will be subject to a COA and the processing described in CBOE Rule 6.53C, Interpretation and Policy .10(c).<sup>11</sup> CBOE believes that automatically initiating a COA when a resting complex order becomes marketable will provide an opportunity for market participants to match or improve the net price and provide an opportunity for automatic execution before a marketable complex order is routed for manual handling to PAR or a booth.

CBOE believes that revising its rules to prevent complex orders in Hybrid 3.0 classes from executing automatically against individual quotes in the EBook will help to prevent complex orders from executing automatically at potentially erroneous prices. CBOE notes that a market maker must send updates for all of its quotes in the individual series legs in response to a

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<sup>7</sup> CBOE Rule 6.53C, Interpretation and Policy .10.

<sup>8</sup> CBOE Rule 6.53C, Interpretation and Policy .10.

<sup>9</sup> CBOE Rule 6.53C, Interpretation and Policy .10(c).

<sup>10</sup> CBOE Rule 6.53C, Interpretation and Policy .10(c).

<sup>11</sup> CBOE Rule 6.53C, Interpretation and Policy .10(d).

change in the price of the underlying security or index. For SPX options, the only options class currently traded on the Hybrid 3.0 platform, this may include thousands of series. CBOE states that it would be possible for a market maker to trade unintentionally with another market maker or market participant via COB or COA before the market maker's quote update(s) in the individual series leg is processed, which could result in an execution at price(s) that were not intended and that could be extreme or potentially erroneous.<sup>12</sup> CBOE believes that the limitation on complex order executions against a market maker's quotations in Hybrid 3.0 classes will address an operational issue that could discourage market makers, particularly Lead Market Makers, from offering additional liquidity in individual series legs.<sup>13</sup>

### III. Discussion and Commission's Findings

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.<sup>14</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>15</sup> 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 impediments to and perfect

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<sup>12</sup> According to CBOE, the Exchange has recognized the need to ameliorate small timing differences in processing market maker quotation updates by delaying market maker quotations from executing against each other for up to one second. See, e.g., CBOE Rule 6.45B(d).

<sup>13</sup> CBOE notes that on the Hybrid 3.0 platform, the quotes represent aggregate market maker quoting interest in a series for the trading crowd, but the Lead Market Maker is responsible for generating the quotes and satisfying trades against those quotes in relation to executions occurring through COB or COA.

<sup>14</sup> 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).

<sup>15</sup> 15 U.S.C. 78f(b)(5).

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 limitation on automatic executions of marketable complex orders against individual leg market quotations for options classes traded on CBOE's Hybrid 3.0 trading platform is consistent with the Act. According to CBOE, the limitation is designed to address an operational issue that CBOE believes could discourage market makers, particularly Lead Market Makers, from offering additional liquidity in the individual series legs. This operational issue may arise when a market maker unintentionally trades with another market maker or market participant via COB or COA before the market maker's quote update(s) in the individual series leg(s) is processed. By addressing an operational issue that might discourage market makers from offering additional liquidity in the individual series legs, the Commission believes that the limitation on automatic executions of marketable complex orders against market makers' quotations in the individual series legs could benefit investors by helping to increase liquidity in the individual series legs. In addition, the Commission notes that it approved a proposal by the International Securities Exchange, LLC ("ISE") that limits the automatic execution of market makers' complex order quotations against bids and offers in the individual series legs.<sup>16</sup>

Under CBOE Rule 6.53C, Interpretation and Policy .10, a marketable complex order may execute automatically against individual orders in the EBook, provided that the complex order can be executed in full or in a permissible ratio and the orders in the EBook are priced equal to or

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<sup>16</sup> See Securities Exchange Act Release No. 65548 (October 13, 2011), 76 FR 64980 (October 19, 2011) (order approving File No. SR-ISE-2011-39).

better than the individual quotes in the EBook.<sup>17</sup> The Commission believes that this requirement will prevent any leg of a complex order from trading at a price that is inferior to the best quote for the series in the EBook. CBOE Rule 6.53, Interpretation and Policy .01 provides, further, that complex orders that are marketable against each other will execute automatically only if the execution is at a net price that has priority over the individual orders and quotes in the EBook.<sup>18</sup> The Commission believes that this provision will maintain the current requirements for a complex order to obtain priority over individual orders and quotes in the EBook.

Under CBOE Rule 6.53C, Interpretation and Policy .10, the allocation of marketable complex orders against orders in the EBook and against other complex orders will be based on the best net price(s), and multiple orders at the same net price will be allocated as provided in CBOE Rules 6.53C(c) and/or (d), as applicable.<sup>19</sup> Accordingly, the proposal applies the requirements of the existing COB and COA allocation frameworks to determine how a marketable complex order would be allocated against individual orders in the EBook and other complex orders at the same net price.

Any part of a marketable complex order that can be executed in full or in a permissible ratio when it is routed to COB or after being subject to a COA will be executed automatically, and the part of the order that cannot execute automatically will route to PAR or to the order entry firm's booth.<sup>20</sup> If the order is not eligible to route to PAR, the remaining balance will be

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<sup>17</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(b).

<sup>18</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(b).

<sup>19</sup> See CBOE Rule 6.53C, Interpretation and Policy .10. CBOE Rule 6.53C(c) describes the operation of the COB, and CBOE Rule 6.53C(d) describes the operation of the COA.

<sup>20</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(c).

cancelled.<sup>21</sup> The Commission believes that these provisions will advise market participants of the treatment of marketable complex orders that cannot be executed in full or in a permissible ratio by clearly describing the processing of these orders.

A complex order resting in COB that becomes marketable but cannot be executed automatically in full or in a permissible ratio will be subject to a COA.<sup>22</sup> The Commission believes that subjecting such orders to a COA could provide an opportunity for price improvement and facilitate the execution of marketable complex orders.

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>23</sup> that the proposed rule change (SR-CBOE-2011-114) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

Kevin M. O’Neill  
Deputy Secretary

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<sup>21</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(c).

<sup>22</sup> See CBOE Rule 6.53C, Interpretation and Policy .10(d).

<sup>23</sup> 15 U.S.C. 78s(b)(2).

<sup>24</sup> 17 CFR 200.30-3(a)(12).