

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66348; File No. SR-CBOE-2011-122)

February 7, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Related to Trading of FLEX Options

I. Introduction

On December 12, 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 proposed rule change to amend rules pertaining to the electronic trading of Flexible Exchange Options (“FLEX Options”) and to eliminate certain European-Capped style settlement and currency provisions with the FLEX rules that pertain to both electronic and open outcry trading. The proposed rule change was published for comment in the Federal Register on December 29, 2011.<sup>3</sup> On February 7, 2012, the Exchange filed an Amendment No. 1 to the proposed rule change.<sup>4</sup> The Commission received one comment letter regarding the proposal.<sup>5</sup> This order approves the proposed rule change, as modified by Amendment No. 1.

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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. 66035 (December 22, 2011), 76 FR 82017 (“Notice”).

<sup>4</sup> Amendment No. 1 amended the proposed rule change to provide an implementation plan of the proposed rule changes. The Exchange intends to begin implementation by no later than March 30, 2012, with the specific implementation schedule to be announced via Regulatory Circular. Since Amendment No. 1 does not alter the substance of the proposal, it is not subject to notice and comment.

<sup>5</sup> See letter from Todd Weingart, Spot On Brokerage Services, Division of Trading Block, William O’Keefe, Spot On Brokerage Services, Division of Trading Block, and Steve Stepanek, The SJS Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated January 20, 2012.

## II. Description of the Proposal

The Exchange is in the process of enhancing the FLEX Hybrid Trading System platform (“FLEX System”) to further integrate it with the Exchange’s existing technology platform for non-FLEX trading. Accordingly, the Exchange proposes to make certain modifications to the existing electronic trading processes utilized on the FLEX System platform. The Exchange does not propose any changes to the open outcry trading processes for FLEX Options, except for proposed changes pertaining to foreign currencies as described below.

### A. Opening Trading in Existing Series

The Exchange proposes to revise the procedure for opening FLEX Option series with existing open interest. Currently there are no trading rotations conducted at the opening of trading.<sup>6</sup> Instead, an initial FLEX Request for Quote (“RFQ”) process is required to open a particular series for trading each day. Once an RFQ is completed, the series is established in the FLEX System for the day and FLEX Orders<sup>7</sup> may be entered directly into the FLEX electronic book throughout the day.<sup>8</sup>

Under the proposal, FLEX Option series with existing open interest will be automatically opened by the Exchange at a randomly selected time within a number of seconds after 8:30 a.m. (Central Time), at which point in time FLEX Orders may be entered directly into the electronic book (if available) and/or FLEX RFQ auctions may be initiated pursuant to Rule 24B.5. New FLEX Option series will continue to be subject to the existing requirement that there be an initial RFQ to initiate trading in the FLEX series on a given trading day.

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<sup>6</sup> See Rule 24B.3.

<sup>7</sup> See Rule 24B.1(j).

<sup>8</sup> Resting FLEX Orders may only be entered in the electronic book as “day orders” and are cancelled at the close of each trade day if unexecuted. Therefore, there would be no orders resting in the book from the prior day.

## B. Trade Conditions

Under Rule 24B.1, a “Trade Condition” means a contingency that has been placed on an RFQ, RFQ Order<sup>9</sup> or FLEX Order. There are currently six Trade Conditions available in the FLEX System.<sup>10</sup> The Exchange proposes to eliminate the Fill-or-Kill, Minimum Fill, Lots Of, and Intent to Cross Trade Conditions, as their functions will not be supported under the FLEX System enhancements. In addition, the Exchange represents that these Trade Conditions have generally not been actively used by FLEX Traders. The Exchange also proposes to adopt a new Immediate-or-Cancel Trade Condition. “Immediate-or-Cancel” will be defined as a condition to execute an RFQ Order or FLEX Order in its entirety or in part as soon as it is represented or cancel it. Thus, under the proposal, there will only be three Trade Conditions: Immediate-or-Cancel, All-or-None, and Hedge.

## C. Foreign Currency Provisions

The Exchange also proposes to eliminate the provisions in the FLEX Rules that permit (i) FLEX Options to be designated with a European-Capped style exercise and (ii) FLEX Index Options to be designated for settlement in foreign currencies. In addition, related index multiplier provisions for foreign currencies will also be eliminated. The changes will apply to all FLEX trading on the Exchange, whether electronic or open outcry. According to the Exchange, these European-Capped style and foreign currency provisions have generally not been actively utilized, and the Exchange no longer plans to support foreign currency settlements in the enhanced FLEX System.

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<sup>9</sup> See Rule 24B.1(t).

<sup>10</sup> See Rule 24B.1(y)(1)-(6).

D. Electronic Allocation Algorithms

Further, the Exchange proposes to modify and simplify the allocation algorithms applicable to the FLEX electronic book and to the FLEX electronic RFQ process. Generally, the algorithms will be based on price-time priority, subject to public customer and non-Trading Permit Holder broker-dealer (“non-TPH broker-dealer”) priority and, if applicable, any applicable entitlement priority. The specific allocation algorithms for the FLEX electronic book and the FLEX electronic RFQ process are described below.

1. FLEX Electronic Book

Currently, for the FLEX electronic book, all FLEX Orders are ranked and matched based on price-time priority, unless a FLEX Appointed Market-Maker is quoting at the best bid (offer) and a FLEX Appointed Market-Maker participation entitlement has been established.<sup>11</sup> If a FLEX Appointed Market-Maker participation entitlement has been established, priority among multiple bids (offers) at the same price is as follows: (i) all FLEX Orders for the account of a public customer ranked ahead of the FLEX Appointed Market-Maker, based on time priority; (ii) any FLEX Orders that are subject to the FLEX Appointed Market-Maker participation entitlement, based on a participation entitlement formula specified in Rule 24B.5(d)(2)(ii); then (iii) all other FLEX Orders, based on time priority.

As proposed, priority for the FLEX electronic book with multiple bids (offers) at the same price would be: (i) public customer and non-TPH broker-dealers will participate in the execution based on time priority; (ii) any FLEX Orders that are subject to the FLEX Appointed

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<sup>11</sup> The Exchange may establish from time to time a participation entitlement formula that is applicable to FLEX Appointed Market Makers on a class-by-class basis with respect to open outcry RFQs, electronic RFQs and/or electronic book transactions. See Rule 24B.5(d)(2)(ii).

Market-Maker participation entitlement, based on a participation entitlement formula specified in Rule 24B.5(d)(2)(ii); then (iii) all other FLEX Orders will participate in the execution, based on time priority.

2. FLEX Electronic RFQs

Pursuant to the current electronic RFQ process, executions of RFQ Orders occur at a single price that will leave bids and offers which cannot trade with each other (referred to as the “BBO clearing price”). In determining the priority of bids and offers, the FLEX System gives priority to FLEX Quotes<sup>12</sup> and FLEX Orders whose price is better than the BBO clearing price, then to FLEX Quotes and FLEX Orders at the BBO clearing price. Priority among multiple FLEX Quotes and FLEX Orders priced at the BBO clearing price is generally as follows: (i) any FLEX Quotes subject to a FLEX Appointed Market-Maker participation entitlement; (ii) FLEX Orders resting in the electronic book, based on the current book priority algorithm; (iii) FLEX Quotes for the account of public customers and non-TPH broker-dealers, based on time priority; and then (iv) all other FLEX Quotes, based on time priority.

The Exchange proposes to eliminate the concept of a “BBO clearing price” except in the limited scenario where the RFQ Market is locked or crossed. Thus, an incoming FLEX electronic RFQ Order would be eligible to trade with FLEX Quotes and FLEX Orders at the best price(s) (i.e., an incoming RFQ Order could trade at multiple price points). In general, priority among multiple FLEX Quotes and FLEX Orders at the same price would be: (i) FLEX Quotes and FLEX Orders for the account of public customers and non-TPH broker-dealers, based on time priority; (ii) any FLEX Quotes and FLEX Orders subject to a FLEX Appointed Market-

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<sup>12</sup> See Rule 24B.1(k).

Maker participation entitlement; and then (iii) all other FLEX Quotes and FLEX Orders, based on time priority.

a. Lock/Crossed Markets

Currently, in the event the RFQ Market<sup>13</sup> is locked or crossed (e.g., \$1.25-\$1.20), priority among multiple FLEX Quotes and FLEX Orders that are priced at the BBO clearing price and are on the same side of the market as the RFQ Order is as follows: (i) FLEX Orders resting in the electronic book, based on the current book priority algorithm; (ii) if applicable, an RFQ Order for the account of a public customer or non-TPH broker-dealer, then any FLEX Quotes subject to a FLEX Appointed Market-Maker participation entitlement; (iii) FLEX Quotes for the account of public customers and non-TPH broker-dealers, based on time priority; (iv) if applicable, an RFQ Order for the account of a Trading Permit Holder, then any FLEX Quotes that are subject to a FLEX Appointed Market-Maker participation entitlement; and then (v) all other FLEX Quotes, based on time priority.

As noted above, the Exchange proposes to eliminate the concept of a “BBO clearing price” except in the limited scenario where the RFQ Market is locked or crossed. Under the proposal, in the event the RFQ Market is locked or crossed, FLEX Quotes and FLEX Orders would be eligible to trade at a single BBO clearing price pursuant to the existing BBO clearing price process. The priority among multiple FLEX Quotes and FLEX Orders that are priced at the same price and are on the same side of the market as the RFQ Order will be: (i) FLEX Quotes and FLEX Orders for the account of public customers and non-TPH broker-dealers, based on time priority; (ii) an RFQ Order, then any FLEX Quotes and FLEX Orders that are

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<sup>13</sup> The “RFQ Market” means the bids or offers, or both, as applicable, entered in response to an electronic Request for Quotes and FLEX Orders resting in the electronic book. See Rule 24B.1(s).

subject to a FLEX Appointed Market-Maker participation entitlement; and then (iii) all other FLEX Quotes and FLEX Orders, based on time priority.

b. Intent to Cross Trade Condition

Currently, in the event the Submitting Trading Permit Holder has indicated an Intention to Cross in its RFQ request, the Submitting Trading Permit Holder may obtain a crossing participation entitlement if certain conditions are met. The incoming RFQ Order will then be eligible to trade with the FLEX Quotes and FLEX Orders at the BBO clearing price. Priority among multiple FLEX Quotes and FLEX Orders that are priced at the BBO clearing price and on the same side of the market as the crossing participation entitlement is as follows: (i) FLEX Orders resting in the electronic book based on the current book priority algorithm; (ii) FLEX Quotes for the account of public customers and non-TPH broker-dealers, based on time priority; (iii) the crossing participation entitlement; (iv) any FLEX Quotes subject to a FLEX Appointed Market-Maker participation entitlement; and then (v) all other FLEX Quotes, based on time priority.

Under the proposal, the Exchange would eliminate the “Intent to Cross” Trade Condition. As a result, the Intent to Cross/Crossing Participation Entitlement scenario under the electronic RFQ process described above would no longer be applicable.<sup>14</sup>

E. Electronic RFQ Processing of Complex Orders

Finally, the Exchange proposes to adopt a new Interpretation and Policy under Rule 24B.5 to more fully describe the electronic processing of complex orders. Specifically, complex orders will only be eligible to electronically trade with other complex orders through the electronic RFQ process described in Rule 24B.5(a)(1). To the extent the Exchange determines to

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<sup>14</sup> See proposed changes to Rule 24B.5(a)(1)(iii)(D) and (d)(2)(i).

make an electronic book available for simple, resting FLEX Orders, there will be no “legging” of complex orders represented in the electronic RFQ process with FLEX Orders that may be represented in the individual series legs represented in the electronic book. In the event there are bids (offers) in any of the individual component series legs represented in the electronic book when an electronic RFQ for a complex order strategy is submitted to the System, the electronic RFQ will not commence. In the event an unrelated FLEX Order in any of the individual series legs is received during the duration of an electronic RFQ, such FLEX Order will not be considered in the electronic RFQ allocation. Further, to the extent that a complex RFQ Order or responsive FLEX Quote is not executed, any remaining balance of the complex order or FLEX Quote will be automatically cancelled if not traded at the conclusion of the electronic RFQ process.

### III. Discussion and Commission Findings

After careful consideration, 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>15</sup> and, in particular, the requirements of Section 6 of the Act.<sup>16</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>17</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, 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 proposal

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<sup>15</sup> In approving the proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>16</sup> 15 U.S.C. 78f.

<sup>17</sup> 15 U.S.C. 78f(b)(5).



should benefit FLEX Traders and investors by providing a more simplified and efficient trading functionality that competes with the over-the-counter market in customized options.

The Exchange proposes to revise the process for opening electronic trading in FLEX Option series with existing open interest. The Commission believes that the proposal to automatically open FLEX Option series with existing open interest could make the opening process more efficient for FLEX users. In addition, the Commission notes that new FLEX Option series will continue to be subject to the existing requirement that there be an initial RFQ to initiate trading in the FLEX series.

In addition, the Exchange proposes to eliminate the Fill-or-Kill, Minimum Fill, Lots Of, and Intent to Cross Trade Conditions, and to adopt a new Immediate-or-Cancel Trade Condition. Furthermore, the Exchange proposes to eliminate European-Capped exercise style and foreign currency provisions for FLEX Options. The Commission notes that the proposed changes help to clarify the procedures utilized in the Exchange's enhanced FLEX System and should help encourage further use of FLEX Options. The Commission notes that the eliminated Trade Conditions and foreign currency settlement provisions will not be supported under the FLEX System enhancements. Also, according to the Exchange, the eliminated Trade Conditions, as well as the European-Capped style and foreign currency provisions have generally not been actively used by FLEX Traders.

The Exchange also proposes to adopt a new Interpretation and Policy to Rule 24B.5 to describe the electronic processing of complex orders. The Commission believes that such a provision will clarify application of Exchange rules and processes for CBOE Trading Permit Holders and investors.

The Exchange further proposes to modify the priority algorithms applicable to the FLEX electronic book and to the FLEX electronic RFQ process. The Commission believes that the proposed changes will simplify the allocation algorithms for FLEX Traders and investors. Under the proposal, allocation will be based on price-time priority, subject to public customer and non-TPH broker-dealer priority and, if applicable, any applicable entitlement priority. The Commission believes that the priority and allocation rules are reasonable and consistent with the Act and applies a more consistent allocation algorithm across these FLEX electronic processes.<sup>18</sup> Moreover, the proposed changes regarding public customer priority/non-TPH broker-dealer priority and price-time priority have previously been found consistent with the Act.<sup>19</sup>

The Commission received one comment letter regarding the proposed rule change.<sup>20</sup> The comment suggested that there be an additional phase, the Decision Phase, in the RFQ process. During this Decision Phase, the initiator of an RFQ would have a brief period of time, during

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<sup>18</sup> The Commission also believes that the amended priority and allocation rules for electronic FLEX trading are consistent with Section 11(a) of the Act. 15 U.S.C. 78k(a) Section 11(a)(1) prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion unless an exception applies. The Commission believes, however, that neither a Submitting Trading Permit Holder who trades against an electronic RFQ Market nor any other FLEX Trader who itself submits an RFQ Quote electronically qualifies for the "effect-versus execute" exception to Section 11(a). 17 CFR 240.11a2-2(T). Nevertheless, the Commission believes that other exceptions may apply. FLEX Market-Makers qualify for the market-maker exception. With respect to non-market-maker members, the new System appears reasonably designed to cause RFQ Quotes constituting the RFQ Market and the RFQ Order that trades against the RFQ Market to yield to non-member interest, consistent with the "G" exception. See 15 U.S.C. 78k(a)(1)(G) (setting forth all requirements for the "G" exception).

<sup>19</sup> See e.g., Securities Exchange Act Release Nos. 51822 (June 10, 2005), 70 FR 35321 (June 17, 2005) (SR-CBOE-2004-87) (Adopting rules pertaining to priority and allocation of trades for index options) and 56792 (November 15, 2007), 72 FR 65776 (November 23, 2007) (SR-CBOE-2006-99) (Adopting rules providing for the trading of FLEX Options on an electronic platform).

<sup>20</sup> See supra note 4.

which no changes of any type to market quotes would be permitted, in order to decide to trade or cancel their RFQ.<sup>21</sup> According to the Exchange, it previously proposed an RFQ process with a “locked up RFQ Market,” similar to the one suggested in the comment letter, during the Reaction Phase. However the Exchange amended the process to allow FLEX Quotes and FLEX Orders to be entered, modified or cancelled during the Reaction Phase.<sup>22</sup> The Exchange stated that the amendment was the result of feedback received concerning the risk of market movements that might occur during the “locked up RFQ Market.”<sup>23</sup> The Commission agrees with the Exchange that the five-minute RFQ Reaction Period should be sufficient time for the Submitting Trading Permit Holder to determine whether to trade against the RFQ Market while at the same time not exposing those who respond to an RFQ to any unreasonable risks of market movements that may occur during the RFQ Reaction Period.

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>24</sup> that the

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<sup>21</sup> Id.

<sup>22</sup> See Securities Exchange Act Release No. 56792, supra note 19.

<sup>23</sup> See SR-CBOE-2006-99 Amendment No. 2, <http://www.cboe.com/publish/RuleFilingsSEC/SR-CBOE-2006-099.a2.pdf>.

<sup>24</sup> 15 U.S.C. 78s(b)(2).

proposed rule change (File No. SR-CBOE-2011-122), as amended by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>25</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>25</sup> 17 CFR 200.30-3(a)(12).