

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66394; File No. SR-CBOE-2012-005)

February 14, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change Related to Stock-Option Processing

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 7, 2012, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange is proposing to amend its complex order processing rules to revise the procedures for electronically processing stock-option orders. The text of the rule proposal is available on the Exchange’s website (<http://www.cboe.org/legal>), at the Exchange’s Office of the Secretary and at the Commission.

II. Self-Regulatory Organization’s Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places

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

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

specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to revise is [sic] procedures for electronically processing stock-option orders under Rule 6.53C in order to (i) revise the procedures for routing the stock leg of a stock-option order; (ii) modify the procedure for executing for [sic] stock-option orders to no longer permit “legging,” except in one limited context; (iii) modify the default electronic allocation algorithm applicable for stock-option orders in the complex order book (“COB”) and the complex order RFR auction (“COA”);<sup>3</sup> (iv) incorporate an additional price check parameter specific to the electronic processing of stock-option orders and modify an existing price check parameter and re-COA features (described in more detail below) to apply to stock-option orders; and (v) make other changes to reorganize and simplify the rule text. In addition, the Exchange is proposing certain changes to simplify the definitions for complex orders, including stock-option orders, subject to electronic processing under Rule 6.53C.

Designated Broker-Dealer(s)

The first purpose of this proposed rule change is to revise the procedures for routing the stock leg of a stock-option order. Interpretation and Policy .06 to Rule 6.53C, Complex Orders on the Hybrid System, currently describes the procedure for processing electronic stock-option orders. The procedure provides that the stock portion of a stock-option order shall be electronically executed on the CBOE Stock Exchange, LLC (“CBSX,” CBOE’s stock execution

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<sup>3</sup> COA is a process for auctioning eligible complex orders, including stock-option orders, for price improvement. See Rule 6.53C(d) and .06(d).

facility) consistent with CBSX order execution rules. The Exchange proposes to revise the process to instead provide that the Exchange will electronically transmit orders related to a stock leg for execution by a broker-dealer designated by the Exchange (a “designated broker-dealer”) on behalf of the parties to the trade. The Exchange will transmit the underlying stock leg order to a designated broker-dealer for execution once the Exchange trading system determines that a stock-option order trade is possible and at what net prices. The stock leg component will be transmitted to the designated broker-dealer as two paired orders with a designated limit price, subject to one limited exception pertaining to the stock leg of an unmatched market stock-option order (which is described in more detail below). The designated broker-dealer will act as agent for the stock leg of the stock-option orders. The designated broker-dealer may determine to match the orders on an exchange or “over-the-counter.”

To participate in this automated process for stock-option orders, an Exchange Trading Permit Holder (“TPH”) must enter into a customer agreement with one or more designated broker-dealers that are not affiliated with the Exchange.<sup>4</sup> In addition, TPHs may only submit complex orders with a stock component if such orders comply with the Qualified Contingent Trade Exemption (the “QCT Exemption”) from Rule 611(a) of Regulation NMS.<sup>5</sup> TPHs submitting such complex orders represent that such orders comply with the QCT Exemption. The Exchange intends to address fees related to routing the stock portion of stock-option trades in a separate rule change filing.

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<sup>4</sup> This provision for a designated broker-dealer is similar to a provision in the International Securities Exchange Rule 722.02, except that CBOE’s proposed provision makes it clear the broker-dealer(s) that are designated by the Exchange to perform this function are not affiliated with CBOE.

<sup>5</sup> 17 CFR 242.611(a).

The Exchange believes that the electronic communication of the orders by the Exchange to the designated broker-dealer is a more efficient means for processing stock-option orders than the system of routing orders to CBSX. The designated broker-dealer will be responsible for the proper execution, trade reporting and submission to clearing of the stock trade that is part of a stock option order. In this regard, once the orders are communicated to the broker-dealer for execution, the broker-dealer has complete responsibility for determining whether the orders may be executed in accordance with all the rules applicable to execution of equity orders, including compliance with the applicable short sale, trade-through and trade reporting rules. As with the current procedure, if the broker-dealer cannot execute the equity orders at the designated price, the stock-option combination order will not be executed on the Exchange.<sup>6</sup>

With respect to trade throughs in particular, the Exchange believes that the stock component of a stock-option order is eligible for the QCT Exemption from Rule 611(a) of Regulation NMS. A Qualified Contingent Trade (“QCT”) is a transaction consisting of two or more component orders, executed as agent or principal, that satisfy the six elements in the Commission’s order exempting QCTs from the requirements of Rule 611(a), which requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs.<sup>7</sup> The Exchange believes that the stock portion of a complex order under this proposal complies with all six requirements.<sup>8</sup> Moreover, as explained

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<sup>6</sup> See existing Rule 6.53C.01(a) and proposed changes thereto.

<sup>7</sup> See Securities Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) (“QCT Release”); see also Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006).

<sup>8</sup> As discussed in more detail below, the stock component of all stock-option orders will be transmitted to a designated routing broker as paired stock orders with a specified limit price, with one limited exception. The exception pertains to the stock leg of an unmatched market stock-option order. In the limited circumstances when the Exchange

below, CBOE's Hybrid System will validate compliance with each requirement such that any matched order received by a designated broker-dealer under this proposal has been checked for compliance with the exemption to the extent noted below:

- (1) at least one component order is in an NMS stock: the stock component must be an NMS stock, which is validated by the Hybrid System;
- (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent: a complex order, by definition, is executed at a single net credit/debit price and this price contingency applies to all the components of the order, such that the stock price computed and sent to the designated broker-dealer allows the stock order to be executed at the proper net debit/credit price based on the execution price of each of the option legs, which is determined by the Hybrid System;
- (3) the execution of one component is contingent upon the execution of all other components at or near the same time: once a stock-option is accepted and validated by the Hybrid System, the entire package is processed as a single transaction and each of the option leg(s) and stock components are simultaneously processed;
- (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed: stock-option orders, upon entry, must have a size for each component and a net debit/credit price (or market price), which the Hybrid System validates and processes to determine the ratio between the components; an order is rejected if the net debit/credit

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transmits the stock component leg of an unmatched market stock-option order to the designed [sic] routing broker, such a stock component leg will be subject to NBBO pricing (and therefore not be processed subject to the QCT Exemption).

price (or market price) and size are not provided on the order;

(5) the component orders 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 since cancelled: under this proposal, the stock component must be the underlying security respecting the option leg(s), which is validated by the Hybrid System; and

(6) the transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade: under this proposal and as discussed in more detail below, the ratio between the options and stock must be a conforming ratio (e.g., largest option leg to stock cannot exceed a ratio of eight-to-one and multiple options legs cannot exceed a ratio of three-to-one), which the Hybrid System validates, and which under reasonable risk valuation methodologies, means that the stock position is fully hedged. In addition, if all option and stock component legs are on the same side of the market, which the Hybrid System also validates, then the order will not be eligible for electronic processing pursuant to Rule 6.53C.

Furthermore, as noted above, proposed Rule 6.53C.06(a) provides that TPHs may only submit complex orders with a stock component if such orders comply with the QCT Exemption. TPHs submitting such complex orders with a stock component represent that such orders comply with the QCT Exemption. Thus, the Exchange believes that complex orders consisting of a stock component will comply with the exemption and that the Hybrid System will validate such compliance as noted above to assist its designated routing broker(s) in carrying out its responsibilities as agent for these orders.

The Exchange believes the new process offers effective and efficient automatic execution for both the options and stock components of a stock-option order and it should promote just and equitable principles of trade and remove impediments to and perfect the mechanism of a free and open market and a national market system by enhancing the electronic processing of the stock-option orders. However, this process is not exclusive. The Exchange notes that TPHs will be able to continue using open outcry procedures for executing stock-option orders if they choose to do so.<sup>9</sup> TPHs can also utilize other exchanges' systems (several of which offer stock-option processing) or avoid using stock-option orders.

### Legging

In conjunction with this change, the second purpose of this proposed rule change is to revise the stock-option procedure to provide that “legging” against the individual orders and quotes in the CBOE and CBSX electronic books (“EBooks”) will no longer occur for stock-option orders,<sup>10</sup> except that that legging may occur in the limited instance provided in Rule 6.53C.06(d) for eligible market orders that have been subject to a COA (which market order process is proposed to be revised as described below).<sup>11</sup> The Exchange believes that limiting the electronic trading of stock-option orders pursuant to Rule 6.53C to executions against other

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<sup>9</sup> Stock-option orders may be represented in open outcry by floor brokers or Exchange PAR Officials. See, e.g., Rules 6.45A(b) and 6.45B(b).

<sup>10</sup> Currently under Rule 6.53C complex orders, including stock-option orders, are eligible to trade with other complex orders or by “legging” with the individual orders and quotes residing in the EBook for the individual component legs provided the complex order can be executed in full (or in a permissible ratio) by the orders and quotes in the EBook in those individual component legs. In the case of stock-option orders that are “legged,” the stock leg would trade with CBSX’s EBook and the option series leg(s) with the CBOE EBook.

<sup>11</sup> The Exchange notes that at least one other options exchange that offers electronic complex order processing does not “leg” stock-option orders. See, e.g., NASDAQ OMX PHLX LLC (“Phlx”) Rule 1080.08(f)(iii)(A)(1).

stock-option orders in the manner proposed will provide for more efficient execution and processing of stock-option orders and will assist with the maintenance of fair and orderly markets by helping to mitigate the potential risks associated with legging stock-option orders, including the risk of one leg of the stock-option order going unexecuted (and thereby not achieving a complete stock-option order execution and having a partial position that is unhedged).<sup>12</sup>

A limited exception will continue to apply for certain market stock-option orders, with certain modifications. Currently, under Rule 6.53C.06(d), if at the conclusion of a COA a stock-option order that is an eligible market order<sup>13</sup> cannot be filled in whole or in a permissible ratio, then any remaining balance of the option leg(s) routes to the CBOE Hybrid Trading System for processing as a simple market order(s) consistent with CBOE's order execution rules and any remaining balance of the stock leg routes to CBSX for processing as a simple market order consistent with CBSX's order execution rules.<sup>14</sup> This alternate legging functionality is intended to assist in the automatic execution and processing of stock-option orders that are market orders.

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<sup>12</sup> That is not to say that the Exchange would not determine to permit additional "legging" of stock-option orders under Rule 6.53C in the future. Any such change to the electronic processing of stock-option orders under Rule 6.53C would be subject to a separate rule change filing.

<sup>13</sup> For purposes of this legging functionality, an "eligible market order" means a stock-option order that is within the designated size and order type parameters, determined by the Exchange on a class-by-class basis, and for which the national best bid or offer ("NBBO") is within designated size and price parameters, as determined by the Exchange for the individual leg. The rule currently provides that the designated NBBO price parameters will be determined based on a minimum bid price for sell orders and a maximum offer price for buy orders. The Exchange may also determine to limit the trading times within regular trading hours that the legging functionality will be available. See Rule 6.53C.06(d). Pursuant to Rule 6.53C.01, any determination by the Exchange on these parameters will be announced to TPHs via Regulatory Circular.

<sup>14</sup> Pursuant to Rule 6.53C.01, any determination by the Exchange to route stock-option market orders in this manner will be announced to TPHs via Regulatory Circular.



The Exchange notes that when a stock-option order is legged in this manner, it is possible for CBOE to route the option leg(s) to another options exchange and/or for CBSX to route the stock leg to another stock exchange, consistent with their respective rules.<sup>15</sup> As proposed to be revised, the Exchange may determine to continue to make this “legging” functionality available for stock-option orders that are eligible market orders. The legging functionality will continue to operate in the same manner, with the exception that the stock leg will no longer route to CBSX and an order eligibility provision will be eliminated from the rule.<sup>16</sup> Instead, the Exchange will electronically transmit the stock leg to a designated broker-dealer, who will represent the order on behalf of the party that submitted the stock-option order.

This legging functionality is intended to assist in the automatic execution and processing of stock-option orders that are market orders. The Exchange believes the order eligibility parameters provide the Exchange with the flexibility to assist with the maintenance of orderly markets by helping to mitigate the potential risks associated with legging stock option orders, e.g., the risk of a [sic] order drilling through multiple price points on another exchange (thereby resulting in execution at prices that are away from the NBBO and potentially erroneous), and/or the risk of one leg of the stock-option order going unexecuted (thereby not achieving a complete stock-option order execution and having a partial position that is unhedged).

#### Allocation Algorithms

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<sup>15</sup> See, e.g., CBOE’s Rules 6.14A, Hybrid Agency Liaison 2 (HAL2), and 6.14B, Order Routing to Other Exchanges, and CBSX’s Rule 52.6, Processing of Round-lot Orders.

<sup>16</sup> See note 13, supra, for a description of “eligible market orders.” The Exchange is proposing to eliminate an eligible market order provision that permits the Exchange to specify a designated NBBO price parameter based on a maximum offer price for buy orders. The Exchange has no intention of utilizing this parameter feature and is therefore proposing to delete it from the rules at this time. (By contrast, the Exchange will maintain a provision that permits the Exchange to specify a designated NBBO price parameter based on a minimum bid price for sell orders.) See proposed changes to Rule 6.53C.06(d).

The third purpose of this proposed rule change is to modify the default electronic allocation algorithm applicable for stock-option orders in COB and COA. With respect to COB, Interpretation and Policy .06(b), (c) and (f), taken together, currently provide that stock-option orders submitted to COB will trade in the following sequence: (i) public customer orders resting in the EBook in each of the individual options leg(s) of a stock-option order have first priority; (ii) stock-option orders resting in COB have second priority, with public customer priority and then time priority; and (iii) individual orders and quotes resting in the EBook in each of the individual options leg(s) have third priority provided the order can be executed in full or in a permissible ratio. Because the Exchange is proposing to no longer permit “legging” of orders in COB against the individual orders and quotes in the component legs, the Exchange is proposing to the [sic] amend the algorithm with respect to COB to provide that stock-option orders that are marketable against each other will automatically execute. In the event there are multiple stock-option orders at the same price, they will be allocated pursuant to the rules of trading priority otherwise applicable to incoming electronic orders in the individual series legs (or such other allocation algorithm as the Exchange may designate pursuant to Rule 6.53C.09).<sup>17</sup>

As a condition for a stock-option order to execute against another stock-option order in COB, the execution must be at a net price where the individual options series leg(s) of the stock-option order has priority over the individual orders and quotes residing in the CBOE EBook (the “EBook Priority Condition”). To satisfy the EBook Priority Condition, the individual option

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<sup>17</sup> The allocation algorithms for the individual series legs include price-time, pro-rata, and the ultimate matching algorithm (“UMA”) base priorities and a combination of various optional priority overlays pertaining to public customer priority, Market-Maker participation entitlements, small order preference, and market turner. See Rules 6.45A, Priority and Allocation of Equity Option Trades on the CBOE Hybrid System, and 6.45B, Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System.

series leg(s) of a stock-option order (i) must not trade inferior to CBOE's best bid (offer) in the individual component series, and (ii) must not trade at CBOE's best bid (offer) in the individual component series if one or more public customer orders are resting at the best bid (offer) in each of the component series and the stock-option order could otherwise be executed in full (or in a permissible ratio).

Again, because there will be no legging, the Exchange is also proposing to amend the algorithm with respect to COA. Interpretation and Policy .06(b), (d) and (f), taken together, currently provide that stock-option orders submitted to COA will trade in the following sequence: (i) public customer orders resting in the EBook in each of the individual options leg(s) of a stock-option order have first priority; (ii) public customer stock-option orders resting in COB before, or that are received during, the COA Response Time Interval<sup>18</sup> and public customer responses collectively have second priority, with multiple orders ranked by time priority; (iii) non-public customer stock-option orders resting in the COB before the COA Response Time Interval have third priority, with multiple orders subject to the UMA allocation algorithm described in Rule 6.45A or 6.45B, as applicable; (iv) non-public customer stock-option orders resting in COB that are received during the Response Time Interval and non-public customer responses collectively have fourth priority, with multiple orders subject to the Capped UMA ("CUMA") allocation described in Rule 6.45A or 6.45B, as applicable; and (iv) all other individual orders and quotes residing in the EBook have fifth priority, with multiple interest subject to the UMA allocation algorithm described in Rule 6.45A or 6.45B, as applicable.

Because the Exchange is proposing to no longer permit "legging" of orders in COA against the

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<sup>18</sup> The COA "Responses [sic] Time Interval" means the period of time during which responses to the RFR may be entered. The Exchange determines the length of the Response Time Interval on a class-by-class basis, however, the duration shall not exceed three (3) seconds. See Rule 6.53C(d)(iii)(2).

individual orders and quotes in the component legs (except in the limited instance involving market orders described above), items (i) and (vi) above will no longer be applicable. Instead, the Exchange is proposing to amend the algorithm with respect to COA to provide that, in the event there are multiple stock-option orders at the same price, they will trade in the following sequence: (i) public customer stock-option orders resting in COB before, or that are received during, the COA Response Time Interval and public customer responses collectively have first priority, with multiple orders ranked by time priority; (ii) non-public customer stock-option orders resting in the COB before the COA Response Time Interval have second priority, with multiple orders subject to the UMA allocation algorithm described in Rule 6.45A or 6.45B, as applicable; and (iii) non-public customer stock-option orders resting in COB that are received during the Response Time Interval and non-public customer responses collectively have third priority, with multiple orders subject to the CUMA allocation described in Rule 6.45A or 6.45B, as applicable.

As with COB, as a condition for a stock-option order to execute against another stock-option order through COA, the execution must satisfy the EBook Priority Condition described above.

The system also has some features that would apply to the extent that a stock-option order is or becomes marketable. First, to the extent that a marketable stock-option order cannot automatically execute in full (or in a permissible ratio) when it is routed to COB or after being subject to COA because there are individual orders and quotes residing in the EBook that have priority (but the order resting in COB would not trade against them because there will be no “legging”), any part of the order that may be executed would be executed automatically and the part that cannot automatically execute would be routed on a class-by-class basis to PAR or, at the

order entry firm's discretion, to the order entry firm's booth. If an order is not eligible to route to PAR, then the remaining balance would be cancelled. Second, to the extent that a stock-option order resting in COB becomes marketable against the derived net market (and cannot automatically execute because there is no "legging"), the full order would be subject to COA (and the processing described above). For purposes of this feature, the "derived net market" for a given stock-option strategy would be calculated using the Exchange's best bid or offer in the individual option series leg(s) and the NBBO in the stock leg. The Exchange notes this feature would only be applicable to resting stock-option orders that become marketable against the derived net market. This feature would not be applicable to resting stock-option [sic] that would become marketable with other stock-option orders. Having the system automatically initiate a COA once such a stock-option order resting in COB becomes marketable against the derived net market provides an opportunity for other market participants to match or improve the net price and allows for an opportunity for an automatic execution before a marketable stock-option order is routed for manual handling to PAR or a booth.<sup>19</sup> As noted above, after being subject to COA, any part of the order that may be executed would be executed automatically and the part of the order that cannot automatically execute would be routed on a class-by-class basis to PAR or, at

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<sup>19</sup> The Exchange notes that, in these circumstances when a resting stock-option order becomes marketable, COA will automatically initiate regardless of whether a TPH has requested that the stock-option order be COA'd pursuant to Rule 6.53C.04. In this regard, the Exchange notes that, currently, all of its TPHs have elected to have their COA-eligible orders COA'd. In addition, the Exchange notes that other markets have programs in place that provide for the automatic auctioning of complex orders. See, e.g., Phlx Rule 1080(e)(i)(A) which, among other things, provides that a complex order live auction ("COLA") will initiate if the Phlx system receives a complex order that improves the Phlx complex order best debit or credit price respecting the specific complex order strategy that is the subject of the complex order. During a COLA, Phlx market participants may bid and offer against the COLA-eligible order pursuant to the Phlx Rule.

the order entry firm's discretion, to the order entry firm's booth. If an order is not eligible to route to PAR, then the remaining balance would be cancelled.

The following examples illustrate the operation of the proposed system functionality:

Example 1: Assume an incoming market stock-option order for 75 units is submitted to COA, where the strategy involves the sale of 75 call contracts and purchase of 7,500 stock shares. At the conclusion of COA, assume the best net price response is \$9.13 for 50 units and the best derived net market price is 9.15 for 100 units. The incoming market order to purchase 75 units of the stock-option strategy would receive a partial execution of 50 units at a net price of \$9.13. Because the remaining 25 units are marketable against individual orders and quotes in the EBook, the 25 units would be routed to PAR or, at the order entry firm's discretion, to the order entry firm's booth, for manual handling. If the order would otherwise route to PAR but is not eligible to route to PAR, then the remaining 25 units will be cancelled.<sup>20</sup>

Example 2: Assume a stock-option order for 75 units is resting in COB, where the strategy involves the sale of 75 call contracts and purchase of 7,500 stock shares at a net debit price of \$9.13. By virtue of the fact that it is resting [sic] the COB, the stock-option order is not marketable – meaning there are no orders or quotes within the derived net market price or other stock-option orders within COB against which the resting stock-option order may trade. Assume there are no

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<sup>20</sup> However, if the Exchange has activated the market stock-option order “legging” functionality and the and the [sic] order is eligible, in lieu of routing to PAR or a booth, any remaining balance of the option leg will route to the CBOE Hybrid Trading System for processing as a simple market order and any remaining balance of the stock leg will be electronically transmitted by the Exchange to a designated broker-dealer, who will represent the order on behalf of the party that submitted the stock-option order. See note 13, supra, and surrounding discussion on Legging.

other stock-option orders representing [sic] in the COB for the strategy and also assume the best derived net market price for the strategy is a net price of \$9.15 per unit for 100 units. If the price of the component option series leg or the stock is thereafter updated such that the derived net market price becomes \$9.13 per unit for 100 units, then the full size of the resting stock-option order will become marketable but cannot automatically execute. As a result, the full size (75 units) of the resting stock-option order would be subject to COA. At the conclusion of COA, any part of the stock-option order that may be executed against other stock-option orders or auction responses will be automatically executed. Any part of the order that is marketable and cannot automatically execute (because the stock-option order cannot “leg” against the derived net market) will be routed on a class-by-class basis to PAR or, at the order entry firm’s discretion, to the order entry firm’s booth. If an order is not eligible to route to PAR, then the remaining balance will be cancelled. To the extent any part of the stock-option order is not marketable, it will continue resting in COB.

#### Price Protection and Re-COA Features

The fourth purpose of this proposed rule change is to adopt a new price check parameter applicable to the electronic processing of stock-option orders and to make some modification to an existing price check parameter to address stock-option orders. In particular, the Exchange is proposing to provide that, on a class-by-class basis, the Exchange may determine (and announce to TPHs via Regulatory Circular) to not automatically execute a stock-option order that is marketable if, following COA, the execution would not be within the acceptable derived net market for the strategy that existed at the start of COA. As indicated above, a “derived net

market” for a strategy will be calculated using the Exchange’s best bid or offer in the individual option series leg(s) and the NBBO in the stock leg. An “acceptable derived net market” for a strategy will be calculated using the Exchange’s best bid or offer in the individual option series leg(s) and the NBBO in the stock leg plus/minus an acceptable tick distance. The “acceptable tick distance” will be determined by the Exchange on a class-by-class and premium basis.<sup>21</sup>

Such a stock-option order will route on a class-by-class basis to PAR or, at the order entry firm’s discretion, to the order entry firm’s booth. If an order is not eligible to route to PAR, then the remaining balance will be cancelled. The Exchange believes that users are more concerned about obtaining a net price execution of their stock-option strategy orders than about achieving

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<sup>21</sup> It should be noted that this is simply a parameter for determining whether a stock-option order will be subject to automatic execution, or routed to PAR, a booth or cancelled. A stock-option order that is subject to automatic execution remains subject to the applicable priority requirements prescribed in Rule 6.53C.

It should also be noted that the Exchange has not proposed to prescribe a minimum acceptable tick distance for this parameter (e.g., the acceptable tick distance may be established at 0). This will provide the Exchange with the flexibility to set the price check feature so that automatic executions of stock-option orders must be within the derived net market, which considers the Exchange’s best bid or offer for the options component leg(s) and the NBBO for the stock component leg. The Exchange believes it is reasonable and appropriate to utilize the Exchange best bid and offer in the calculation as the option component leg(s) are not permitted to trade at a price inferior to the Exchange’s best bid and offer. The Exchange also believes it is reasonable and appropriate to consider the NBBO for the stock component leg in the calculation as the NBBO should serve as a reasonable proxy for what may be considered a reasonable price for the automatic execution of the stock component leg. However, the Exchange also recognizes that some range outside the NBBO may also be appropriate for determining whether an automatic execution should occur as the QCT Exemption does not require the stock component leg of a qualifying stock-option order to be executed at the NBBO. The proposed parameter therefore provides the Exchange with the flexibility to determine to utilize the NBBO (which equates to an acceptable tick distance of 0) or some range outside the NBBO (which equates to the derived net part plus/minus an acceptable tick distance of 1, 2, 3 or some other number of ticks) for determining whether to automatically execute a stock-option order.



an execution of the stock leg at the NBBO. The price check parameter, however, would serve to prevent automatic executions at extreme prices beyond the NBBO.

The following example illustrates the operation of the proposed system functionality:

Example 3: Assume that at the start of COA the CBOE best bid and offer for the option leg of a stock-option strategy is \$1.00 - \$1.20 (100 X 100) and the NBBO for the stock leg of the strategy is \$10.05 - \$10.15 (10,000 X 10,000). Thus, the derived net market for the strategy is \$8.85 - \$9.15 (calculated as  $\$1.20 - \$10.05$  and  $-\$1.00 + \$10.15$ , respectively). In addition, assume that the acceptable tick distance for the stock leg is two ticks (\$0.02). Under this parameter, an order to sell stock could not execute at a price below \$10.03 and an order to buy stock could not execute at a price above \$10.17. Thus, the acceptable derived net market for the strategy would be calculated as \$8.83 - \$9.17 (calculated as  $\$1.20 - \$10.03$  and  $-\$1.00 + \$10.17$ , respectively). Under this scenario, following COA, a marketable stock-option order to sell the option series and buy the stock that would trade with another stock-option order at [sic] net debit price of \$9.17 (within the acceptable derived net market for the strategy) will be executed. However, a marketable stock-option [sic] to sell the option series and buy the stock that would trade with another stock-option order at a net debit price of \$9.18 (\$0.01 outside the acceptable derived net market for the strategy) will be routed to PAR or, at the order entry firm's discretion, to the order entry firm's booth. If an order is not eligible to route to PAR, then the remaining balance will be cancelled.

In addition to the foregoing, additional parameters would apply. In classes where these price check parameters are available, they will also be available for COA stock-option responses

under Rule 6.53C(d), stock-option orders and responses under Rules 6.74, Automated Improvement Mechanism (“AIM”), and 6.74B, Solicitation Auction Mechanism (“SAM”), or AIM customer-to-customer immediate cross of stock-option orders under Rule 6.74A.08 (“CTC”).<sup>22</sup> Under these provisions, such paired stock-option orders and responses would not be accepted. In this regard, if any paired stock-option order submitted by an order entry firm for AIM, SAM or CTC processing exceeds the parameters, then both the order that exceeds the parameters and the paired contra-side order would not be accepted regardless of whether the contra-side order exceeds the parameters. However, to the extent that only the paired contra-side order submitted by an order entry firm for AIM or SAM processing would exceed the price check parameter, the paired contra-side order would not be accepted while the original Agency Order would not be accepted or, at the order entry firm’s discretion, continue processing as an unpaired stock-option order (e.g., the original Agency Order would route to COB or COA for processing). The proposal also provides that, to the extent a contra-side order or response is marketable, its price will be capped at the price inside the acceptable derived net market.

Example 4: Assume the acceptable derived net market is \$1.00 - \$1.20. Also assume two paired stock-option orders are submitted to an AIM auction. If the original Agency Order to sell the option leg and buy the stock is a market order, but the contra-side order to buy the option leg and sell the stock has a net credit price of \$1.25, the AIM auction will not initiate because the contra-side order does not satisfy the price check parameter. Such a contra-side order would not be accepted

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<sup>22</sup> AIM, SAM and CTC are mechanisms that may be used to cross two paired orders. COA is a mechanism that may be used to expose an unpaired complex order for price improvement. Orders submitted for COA, AIM or SAM processing are exposed for price improvement through an auction (and thus other market participants may submit responses), whereas orders submitted for CTC processing are executed immediately without exposure.

because it is outside the acceptable net market price range. The paired original Agency Order would either not be accepted along with the contra-side order or, at the order entry firm's discretion, would continue processing as an unpaired complex order. By comparison, if the contra-side order has a net credit price of \$0.95, the price will be capped at \$1.01.

The Exchange is also proposing to modify its existing "market width" parameters under Rule 6.53C.08(a) to extend the application of the individual series leg width parameters to stock-option orders. Under this price check parameter, eligible market complex orders will not be automatically executed if the width between the Exchange's best bid and best offer in any individual series leg is not within an acceptable price range.<sup>23</sup> As proposed, the Exchange may also determine on a class-by-class basis to make this price check parameter available for market and marketable limit stock-option orders.

The Exchange believes that the application of these price protection features will assist with the maintenance of fair and orderly markets by helping to mitigate the potential risks associated with stock-option orders drilling through multiple price points (thereby resulting in executions at prices that are extreme and potentially erroneous). Rather than automatically executing or booking orders at extreme and potentially erroneous prices, the Exchange would

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<sup>23</sup> The "acceptable price range" is determined by the Exchange on a class-by-class basis (and announced to TPHs via Regulatory Circular) on a series by series basis for each series comprising a complex order and is currently defined to be no less than 1.5 times the corresponding bid/ask differentials for individual series legs determined by the Exchange pursuant to Rule 8.7(b)(iv). See also SR-CBOE-2012-004 (wherein the Exchange is proposing, among other things, to expand the application of this price check parameter to include marketable limit orders (currently the rule text only addresses market complex orders) and to specify particular minimum acceptable price ranges within the rule that are equal to 1.5 times the bid/ask differential requirements that the Exchange had in its rules at the time the price check parameters were adopted and are the same as the acceptable price range parameters set forth in Rule 6.13(b)(v) – (vi)).

route orders that are not within the price check parameters to PAR or the order entry firm's booth so that the orders can be further evaluated.

In addition, the Exchange is proposing to extend the application of its "re-COA" feature to stock option orders. Under this feature, to the extent any non-marketable order resting at the top of the COB is priced within the acceptable tick distances of the derived net market, the full order would be subject to COA (referred to herein as a "re-COA").<sup>24</sup> The Exchange notes that this re-COA feature for resting orders would only be applicable to resting non-marketable stock-option orders that move close to the derived net market. This feature is not applicable to resting stock-option orders that become marketable with other stock-option orders. The Exchange may also determine on a class-by-class and strategy basis to limit the frequency of re-COA auctions initiated for stock-option orders resting in COB. For example, the Exchange might determine to limit the frequency of re-COA auctions to once every "X" seconds (the "interval timer") for a total of "Y" intervals. Once this cycle is complete, the Exchange may determine to wait for a period of time "Z" (the "sleep timer") and then reactivate the re-COA feature.<sup>25</sup> All timers would be reset if a new stock-option order improves the top of the COB (i.e., improves the best net price bid or offer of the stock-option orders resting in COB). These limitations on the frequency of COA auctions due to the re-COA feature are intended to address system efficiency and effectiveness considerations, such as limiting repeated initiations of COA auctions (and related messaging) when there are flickering quotes. Once the re-COA feature is initiated for a resting order, all other aspects of the COA process described in Rule 6.53C would apply

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<sup>24</sup> This feature will apply regardless of whether the stock-option order was subject to COA before it was booked in COB. See note 19, supra.

<sup>25</sup> Determinations by the Exchange regarding the classes where the re-COA feature is activated and related tick distance and frequency parameters will be announced to TPHs via Regulatory Circular.

unchanged. The Exchange believes this re-COA feature facilitates the orderly execution of stock-option orders by providing an automated opportunity for price improvement to (and execution of) resting orders priced near the current market, similar to what a TPH might seek to do if the TPH were representing a stock-option order in open outcry (or just entering an order initially into COB).

The following example illustrates the operation of this proposed system functionality:

Example 5: Assume that the acceptable tick distance to re-COA is 2 ticks (\$0.02). Also assume the frequency for the re-COA feature is limited to once every 15 seconds (the interval timer) for 1 interval. Under this setting, only 1 re-COA auctions [sic] could be triggered – the original re-COA auction.<sup>26</sup> No further auctions would be triggered until the sleep timer expires, and only then if a quote update which is received AFTER the sleep timer expires would result in the order being within 2 ticks of the derived net market. Assume the sleep timer is set at 60 minutes. Assume the current derived net market is \$8.85 - \$9.15. If a stock-option order resting in the COB is priced at a net credit price of \$8.88, the stock-option order is not marketable and is priced inside the derived net market by 3 ticks. If subsequently the individual leg prices are updated such that the current derived net market for the strategy moves to a net price of \$8.86 - \$9.14 the resting order

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<sup>26</sup> In a prior rule change filing, the Exchange provided an example indicating that if the setting for the interval timer was once every 15 seconds for 1 interval, then a total of 2 re-COA auctions would occur during the interval – the original re-COA auction and a second re-COA auction after the expiration of the 15-second interval timer. See Securities Exchange Act Release No. 65939 (December 12, 2011), 76 FR 78708 (December 19, 2011)(SR-CBOE-2011-119). However, the Exchange notes that only one re-COA auction will occur under these settings. Therefore, Example 5 above is intended to update the previous example and provide a more detailed illustration of the interval timer.

priced at a net credit price of \$8.88 would trigger the re-COA feature and initiate the re-COA auction process (as the order is now priced within 2 ticks of the derived net market). If there are no responses, the order would be placed back in COB. The resting order would not initiate the re-COA feature again until the 60-minute sleep timer has expired, and only then if a quote update received AFTER the 60-minute sleep timer expires would result in the order being within 2 ticks of the derived net market.

If the number of attempts was set to a value greater than 1 (assume 2 for the below discussion), when the 15-second interval timer expires, the order would be eligible to initiate the re-COA feature again if the current market moves after the expiration of the timer and the order meets the tick distance parameter (the order would not automatically initiate the re-COA feature after the expiration of the interval timer; instead there must be an update to the current market after the expiration of the interval timer and the order must meet the tick distance parameter for the system to re-COA again). For example, if after the end of the 15-second interval timer the derived net market moves to \$8.87 - \$9.13 (or, for example, if the derived market moves back to \$8.85 - \$9.15 and then, after the end of the 15-second interval timer moves back again to \$8.86 - \$9.14), then the resting complex order would again initiate the re-COA feature. If there are no responses, the order would be placed back in COB. The cycle is complete. Now that the resting order has been subject to COA 2 times since it was booked in COB, the 60-minute sleep timer will begin and the resting order will not be eligible for the re-COA feature again until the sleep timer expires and there is a

quote update after that timer expires that is within the tick distance parameter. All timers would be reset anytime there is a price change at the top of the COB. For example, if five minutes into the sleep interval a second stock-option order is entered to rest in COB at a price of \$8.87 (\$0.01 better than the original resting order priced at \$8.88), the original resting order would no longer be at the top of the COB and subject to the re-COA feature. The timers would reset and the second complex order (which now represents the top of the COB) would be subject to the re-COA process. If, for example, the second order subsequently trades (constituting a price change at the top of the COB), the original order would be at the top of the COB again and could become subject to the re-COA feature again.

#### Other Changes Related to Stock-Option Orders

The fifth purpose of this proposed rule change is to make certain other changes to generally reorganize and simplify the rule text pertaining to stock-option orders. As noted above, the current priority rules for stock-option orders for COB are contained in four locations – paragraphs (b), (c) and (f) of Interpretation and Policy .06 to Rule 6.53C. Similarly, the current priority rules for stock-option orders processed through COA are contained in three locations – paragraphs (b), (d) and (f) of Interpretation and Policy .06 of Rule 6.53C. The Exchange is proposing to eliminate paragraph (e)(which provides that the N-second group timer<sup>27</sup> for executions by market participants against orders in the COB shall not be in effect for stock-

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<sup>27</sup> The “N-second group timer” refers to a timer that the Exchange may establish when market participants (as defined in Rule 6.45A or 6.45B, as applicable) quotes and/or orders interact with orders in the EBook. See Rules 6.45A(c), 6.45B(c), 6.53C.03 and proposed changes to Rule 6.53C.06 for additional information on the N-second timer group.

option orders) and to combine it with paragraph (c)(which also addresses executions against the COB). The Exchange is proposing to eliminate paragraph (f) (which relates to stock-option orders with more than one option leg) and to simplify and combine it with paragraph (b) (which relates to stock-option orders with one option leg). The Exchange is also proposing various other miscellaneous changes, such as revising the text to consistently use the term “stock-option order(s)” with no capitalization and to use the phrase “not be accepted” to replace various references to “rejected.”

#### Complex Order Definitions

Finally, the sixth purpose of this proposed rule change is to simplify some of the definitions contained within Rule 6.53C. By way of background, for many years, the options exchanges have recognized that strategies involving more than one option series or more than one instrument associated with an underlying security are different from regular buy and sell orders for a single series, and an order to achieve such strategies should be defined separately. As the sophistication of the industry as [sic] grown, so have the strategies, and the options exchanges have regularly added new strategies to the list of defined complex order types. The investing industry, however, creates new, legitimate investment strategies that do not necessarily fit into one of the narrow definitions for complex order types that the exchanges presently use. These order types are often developed for a particular strategy, specific to a particular issue. To attempt to define every individual strategy, and file additional rules to memorialize them, would be a time consuming and extremely onerous process, and would serve only to confuse the investing public. As a result, bona fide transactions to limit risk are not afforded the facility of execution afforded more common complex orders.



Rule 6.53C currently defines at least ten specific complex strategies (including stock-option order strategies). These are the most comprehensive list of complex strategies defined in a rule set, yet they do not cover all of the possibilities of complex orders. To provide for greater flexibility in the design and use of complex strategies, the Exchange proposes to eliminate specific complex order types described in Rule 6.53C, and to adopt generic definitions. Specifically, under the proposed new definitions, first, a complex order will be defined as any order involving the execution of two or more different options series in the same underlying security, for the same account, occurring at or near the same time in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00) (or such lower ratio as may be determined by the Exchange on a class-by-class basis) and for the purpose of executing a particular investment strategy. In addition, only those complex orders with no more than the applicable number of legs, as determined by the Exchange on a class-by-class basis, will be eligible for electronic processing.<sup>28</sup> Second, a stock-option order will be defined as an order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock (“convertible security”) coupled with the purchase or sale of options contract(s) on the opposite side of the market representing either (i) the same number of units of the underlying stock or convertible security, or (ii) the number of units of the underlying stock necessary to create a delta neutral position, but in no case in a ratio greater than eight (8) options contracts per unit of trading of the underlying stock or convertible security established for that series by The Options Clearing Corporation (referred to in the text as the “Clearing

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<sup>28</sup> Currently the rule limits the number of legs to four. See existing Rule 6.53C(b)(iii). This limitation is proposed to be removed. In addition, a duplicative reference to the one-to-three ratio for complex orders in Rule 6.53C(b)(iii) is proposed to be removed as the applicable ratio will now be included within the proposed definitions contained in proposed Rule 6.53C(a)(1).

Corporation”) (or such lower ratio as may be determined by the Exchange on a class-by-class basis). Only those stock-option orders with no more than the applicable number of legs, as determined by the Exchange on a class-by-class basis, will be eligible for processing.

The Exchange believes adopting these generic definitions will give investors more flexibility in creating strategies with greater accuracy. Further, these definitions would conform with definitions used in other exchanges’ rules<sup>29</sup> and is modeled after the generic definitions approved for use for exemptions from Trade Through Liability by the Options Linkage Authority as described in the “Plan For The Purpose of Creating And Operation An Intermarket Options Linkage” (the “Linkage Plan”) and as provided in Exchange Rules 6.80(4) and 6.81(b)(7).

## 2. Statutory Basis

The proposed rule change is consistent with Section 6(b) of the Act<sup>30</sup> in general and furthers the objectives of Section 6(b)(5) of the Act<sup>31</sup> in particular in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest. The Exchange believes the proposed rule change will assist in the electronic processing of stock-option orders by providing a more efficient mechanism for carrying out these strategies. The Exchange also believes the proposed additional stock-option order related price check parameters will enhance the functionality and assist with the maintenance of fair and orderly markets by helping to mitigate the potential risks associated with an order drilling through multiple price points (thereby resulting in execution at prices that are extreme and potentially

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<sup>29</sup> See, e.g., International Securities Exchange Rule 722(a).

<sup>30</sup> 15 U.S.C. 78f(b).

<sup>31</sup> 15 U.S.C. 78f(b)(5).

erroneous). The Exchange believes the additional changes to reorganize and simplify the rule text will make it easier for users to read and understand the electronic processing procedures for stock-option orders. Finally, the Exchange believes adopting generic definitions for complex orders, including stock-option orders, as proposed, is appropriate in that complex orders and stock-option orders are widely recognized and utilized by market participants and are invaluable, both as an investment strategy and a risk management strategy. The proposed change will provide the opportunity for a more efficient mechanism for carrying out these strategies.

B. Self-Regulatory Organization's Statement on Burden on Competition

CBOE does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange neither solicited nor received comments on the proposal.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve or disapprove such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2012-005 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2012-005. This file number should be included on the subject line if e-mail is used.

To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1090, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the

Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2012-005, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>32</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>32</sup> 17 CFR 200.30-3(a)(12).