

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68585; File No. SR-CBOE-2012-108)

January 4, 2013

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change to Address the Authority to Cancel Orders When a Technical or Systems Issue Occurs and to Describe the Operation of Routing Service Error Accounts

I. Introduction

On November 8, 2012, 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change to (i) address the authority of the Exchange to cancel orders (or release routing-related orders) when a technical or systems issue occurs; and (ii) describe the operation of an Exchange error account(s) and routing broker error account(s), which may be used to liquidate unmatched executions that may occur in the provision of the Exchange’s routing service. The proposed rule change was published for comment in the Federal Register on November 26, 2012.³ The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

In its proposal, the Exchange states that it operates a “hybrid” style system of trading that allows automatic executions to occur electronically and open outcry trades to occur on the floor of the Exchange.⁴ As part of this infrastructure, the Exchange states that it automatically routes

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 68262 (November 19, 2012), 77 FR 70517 (November 26, 2012) (SR-CBOE-2012-108) (“Notice”).

⁴ See Notice, 77 FR at 70518.

orders to other exchanges under certain circumstances. These routing services are provided in conjunction with one or more routing brokers that are not affiliated with the Exchange.⁵

Mechanically, when the Exchange receives an order from a Trading Permit Holder that is held in the Exchange system and determines to route an order to another exchange, the Exchange provides the routing broker with a corresponding order and instructions to route the order to another exchange. The routing broker then sends the corresponding order to the other exchange.

In its proposal, CBOE states that the Exchange may encounter situations that make it necessary to cancel orders (or release routing-related orders),⁶ and to resolve error positions that result from errors of the Exchange, routing brokers, or another exchange.⁷

Proposed Rule 6.6A (Order Cancellation / Release)

New CBOE Rule 6.6A provides CBOE with general authority to cancel orders as it deems to be necessary to maintain fair and orderly markets if a technical or systems issue occurs at the Exchange, a routing broker in connection with the routing service provided under CBOE Rule 6.14B, or another exchange to which an Exchange order has been routed. It also provides that a routing broker may only cancel orders being routed to another exchange based on the Exchange's standing or specific instructions or as otherwise provided in the Exchange Rules. CBOE will be required to provide notice of the cancellation to affected Trading Permit Holders

⁵ See Notice, 77 FR at 70518 n.4, n.8, and accompanying text.

⁶ See Notice, 77 FR at 70518. For examples of some of the circumstances in which the Exchange may decide to cancel orders, see Notice, 77 FR at 70519.

⁷ See Notice, 77 FR at 70518. Specifically, CBOE Rule 6.14C defines "error positions" as "unmatched trade positions that may occur in connection with the routing service provided under Rule 6.14B".

For examples of some of the circumstances that may lead to error positions, see Notice, 77 FR at 70520-21.

as soon as practicable.⁸

Paragraph (b) of the rule provides that the Exchange may also determine to release orders being held on the Exchange awaiting an away exchange execution as it deems to be necessary to maintain fair and orderly markets if a technical or systems issues occurs at the Exchange, a routing broker, or another exchange to which an order has been routed. Paragraph (c) of the rule provides that, for purposes of Rule 6.6A, technical or system issues would include, without limitation, instances where the Exchange has not received confirmation of an execution (or cancellation) on another exchange from a routing broker within a response time interval designated by the Exchange, which interval may not be less than three (3) seconds.

Proposed Rule 6.14C (Routing Service Error Accounts)

New CBOE Rule 6.14C provides that each routing broker shall maintain, in the name of the routing broker, one or more accounts for the purpose of liquidating error positions. In addition the Exchange may also maintain, in the name of the Exchange, one or more Exchange error accounts (“Exchange Error Account”) for the purposes of liquidating error positions, subject to the procedures prescribed in new CBOE Rule 6.14C.

Paragraph (a) of the rule provides that errors to which the rule applies include any action or omission by the Exchange, a routing broker, or another exchange to which an Exchange order has been routed, that results in an unmatched trade position due to the execution of an order that is subject to the away market routing service and for which there is no corresponding order to pair with the execution (each a “routing error”); and that such routing errors would include, without limitation, positions resulting from determinations by the Exchange to cancel or release an order pursuant to CBOE Rule 6.6A.

⁸ See CBOE Rule 6.6A(a).

Paragraph (b) of the rule provides that, generally, each routing broker will use its own error account to liquidate error positions. In certain circumstances, however, the Exchange may use an Exchange Error Account. In particular, in instances where the routing broker is unable to use its own error account (e.g., due to a technical, systems, or other issue that prevents the routing broker from doing so)⁹ or where the error is due to a technical or systems issue at the Exchange, the Exchange may (but would not be required to) determine it is appropriate to use an Exchange Error Account. The Exchange states that in making such a determination to use an Exchange Error Account, the Exchange would consider whether it has sufficient time, information, and capabilities considering the market circumstances to determine that an error is due to such circumstances and whether the Exchange can address the error.¹⁰

Pursuant to paragraph (c), the Exchange will not be permitted to accept any positions in an Exchange Error Account from an account of a Trading Permit Holder or permit any Trading Permit Holder to transfer any positions from the Trading Permit Holder's account to an Exchange Error Account. In other words, the Exchange may not accept from a Trading Permit Holder positions that are delivered to the Trading Permit Holder through the clearance and settlement process, even if those positions may have been the result of an error.¹¹

To the extent a routing broker uses its own account to liquidate error positions, paragraph (d) of new CBOE Rule 6.14 provides that the routing broker shall liquidate the error positions as soon as practicable. The routing broker could determine to liquidate the position itself or have a

⁹ See Notice, 77 FR at 70519.

¹⁰ See Notice, 77 FR at 70520.

¹¹ See Notice, 77 FR at 70520 n.17. This provision would not apply if the Exchange incurred a position to settle a Trading Permit Holder purchase, as the Trading Permit Holder did not yet have a position in its account as a result of the purchase at the time of the Exchange's action. See id.

third-party broker-dealer liquidate the position on the routing broker's behalf. Paragraph (d) also provides that the routing broker shall establish and enforce policies and procedures reasonably designed to (i) adequately restrict the flow of confidential and proprietary information associated with the liquidation of the error position in accordance with Rule 6.14B,¹² and (ii) prevent the use of information associated with other orders subject to the routing services when making determinations regarding the liquidation of error positions. In addition, paragraph (d) provides that the routing broker shall make and keep records associated with the liquidation of such routing broker error positions and shall maintain such records in accordance with Rule 17a-4 under the Act.¹³

Paragraph (e) of the rule provides that, to the extent an Exchange Error Account is used to liquidate error positions, the Exchange shall liquidate the error positions as soon as practicable. In liquidating error positions in an Exchange Error Account, the Exchange shall provide complete time and price discretion for the trading to a third-party broker-dealer and shall not attempt to exercise any influence or control over the timing or methods of such trading.¹⁴ Such a third-party broker-dealer may include a routing broker not affiliated with the Exchange.

¹² Rule 6.14B(b) provides that the Exchange shall establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and the routing broker, and any other entity, including any affiliate of the routing broker, and, if the routing broker or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, between the segment of the routing broker or affiliate that provides the other business activities and the segment of the routing broker that provides the routing services.

¹³ 17 CFR 240.17a-4.

¹⁴ This provision is not intended to preclude the Exchange from providing the third-party broker-dealer with standing instructions with respect to the manner in which it should handle all error account transactions. For example, the Exchange might instruct the broker-dealer to treat all orders as "not held" and to attempt to minimize any market impact on the price of the option being traded.

Paragraph (e) also provides that the Exchange shall establish and enforce policies and procedures reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and the third-party broker-dealer associated with the liquidation of the error positions.

Finally, paragraph (e) provides that the Exchange shall make and keep records to document all determinations to treat positions as error positions under the rule (whether or not an Exchange Error Account is used to liquidate such error positions), as well as records associated with the liquidation of Exchange Error Account error positions through a third-party broker-dealer, and shall maintain such records in accordance with Rule 17a-1 under the Act.¹⁵

III. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b) of the Act¹⁶ and the rules and regulations thereunder applicable to a national securities exchange.¹⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁸ 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 foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in

¹⁵ 17 CFR 240.17a-1.

¹⁶ 15 U.S.C. 78f(b).

¹⁷ 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).

¹⁸ 15 U.S.C. 78f(b)(5).

general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In addition, the Commission believes the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act¹⁹ in that it seeks to assure economically efficient execution of securities transactions.

The Commission recognizes that technical or systems issues may occur, and believes that CBOE Rule 6.6A, in allowing CBOE to cancel or release orders affected by technical or systems issues, should provide a reasonably efficient means for CBOE to handle such orders, and appears reasonably designed to permit CBOE to maintain fair and orderly markets.²⁰

The Commission also believes that allowing the Exchange to resolve error positions through the use of error accounts maintained by its routing brokers or the Exchange itself pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes that the rule establishes criteria for determining which positions are error positions to which the rule applies, and the procedures for the handling of such positions. In particular, the Commission notes that CBOE Rule 6.14C only applies to error positions that result from the Exchange's routing service, and that such positions shall be liquidated by the routing broker or the Exchange, as applicable, as soon as practicable.²¹ In this regard, the Commission believes that the new rule appears reasonably designed to further just and equitable

¹⁹ 15 U.S.C. 78k-1(a)(1)(C).

²⁰ The Commission notes that CBOE states it believes that allowing the Exchange to cancel or release orders under such circumstances would allow the Exchange to maintain fair and orderly markets, and that CBOE Rule 6.14C is designed ensure full trade certainty for market participants and avoid disrupting the clearance and settlement process. See Notice, 77 FR at 70521. The Commission also notes that CBOE states that a decision to cancel or release orders due to a technical or systems issue is not equivalent to the Exchange declaring self-help against a routing destination pursuant to Rule 611 of Regulation NMS. See 17 CFR 242.611(b). See also Notice, 77 FR at 70519 n.9.

²¹ See CBOE Rule 6.14C.

principles of trade and the protection of investors and the public interest, and to help prevent unfair discrimination, in that it should help assure the handling of error positions will be based on clear and objective criteria, and that the resolution of those positions will occur promptly through a transparent process.

The Commission is also concerned about the potential for misuse of confidential and proprietary information. The Commission notes that CBOE or a routing broker, as applicable, will establish and enforce policies and procedures reasonably designed to (1) adequately restrict the flow of confidential and proprietary information associated with the liquidation of the error positions, and (2) in the case of liquidations by a routing broker, prevent the use of information associated with other orders subject to the routing services when making determinations regarding the liquidation of error positions.²² Furthermore, to the extent the Exchange uses an Exchange Error Account to liquidate error positions, the Exchange shall provide complete time and price discretion for the trading to liquidate error positions in an Exchange Error Account to a third-party broker-dealer and shall not attempt to exercise any influence or control over the timing or methods of such trading.²³ The Commission believes that these requirements should help mitigate the Commission's concerns. In particular, the Commission believes that these requirements should help assure that none of CBOE, its routing brokers, or any third-party broker-dealer is able to misuse confidential or proprietary information obtained in connection with the liquidation of error positions for its own benefit. The Commission also notes that routing brokers would be required to make and keep records associated with the liquidation of

²² See CBOE Rules 6.14C(d)(i); 6.14C(e)(ii).

²³ See CBOE Rule 6.14C(e)(i).

routing broker error positions²⁴ and CBOE would be required to make and keep records to document all determinations to treat positions as error positions under this Rule (whether or not an Exchange Error Account is used to liquidate such error positions), as well as records associated with the liquidation of Exchange Error Account error positions through a third-party broker-dealer.²⁵

Finally, the Commission notes that the proposed procedures for canceling orders and the handling of error positions are consistent with procedures the Commission has approved for other exchanges.²⁶

²⁴ See CBOE Rule 6.14C(d)(ii).

²⁵ See CBOE Rule 6.14C(e)(iii).

²⁶ See, e.g., Securities Exchange Act Release Nos. 67281 (June 27, 2012), 77 FR 39543 (July 3, 2012) (SR-NASDAQ-2012-057); 66963 (May 10, 2012), 77 FR 28919 (May 16, 2012) (SR-NYSEArca-2012-22); 67010 (May 17, 2012), 77 FR 30564 (May 23, 2012) (SR-EDGX-2012-08); and 67011 (May 17, 2012), 77 FR 30562 (May 23, 2012) (SR-EDGA-2012-09).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁷ that the proposed rule change (SR-CBOE-2012-108) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁸

Kevin M. O'Neill
Deputy Secretary

²⁷ 15 U.S.C. 78s(b)(2).

²⁸ 17 CFR 200.30-3(a)(12).