SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69328; File No. SR-CBOE-2013-030)

April 5, 2013

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, Relating to the Regulation NMS Plan to Address Extraordinary Market Volatility

I. Introduction

On March 7, 2013, Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to modify its rules to address certain option order types, order handling procedures, obvious error and market-maker quoting obligations on the Exchange after the implementation of the National Market System Plan to Address Extraordinary Market Volatility ("Limit up-Limit Down Plan"). The proposed rule change was published for comment in the Federal Register on March 14, 2013.[3] On March 26, 2013, CBOE filed Amendment No. 1 to the proposed rule change.[4] On April 4, CBOE filed Amendment No. 2 to the proposed rule change.[5] The Commission received one comment letter on the proposed rule change.[6] This

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 69082 (March 8, 2013), 78 FR 16351 ("Notice").

4 See Amendment No. 1 dated March 26, 2013 ("Amendment No. 1"). Amendment No. 1 expanded upon the Exchange's rationale for its proposed changes regarding the nullification and adjustment of options transactions and agreed to provide the Commission with relevant data to assess the impact of the proposal. Additionally, the Exchange provided rationale for terminating the HAL auction early and cancelling of the market orders, discussed infra. Because Amendment No. 1 is technical in nature, it is not subject to notice and comment.

5 See Amendment No. 2 dated April 4, 2013 ("Amendment No. 2"). Amendment No. 2 expanded upon the Exchange's rationale for its proposal to accept certain types of market

order approves the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

II. Background

On May 6, 2010, the U.S. equity markets experienced a severe disruption that, among other things, resulted in the prices of a large number of individual securities suddenly declining by significant amounts in a very short time period before suddenly reversing to prices consistent with their pre-decline levels.[7] This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that were more than 60% away from pre-decline prices. One response to the events of May 6, 2010, was the development of the single-stock circuit breaker pilot program, which was implemented through a series of rule filings by the equity exchanges and by FINRA.[8] The single-stock circuit breaker was designed

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orders during a limit up-limit down state, its proposal to cancel and replace limit orders with market orders during a limit up-limit down state, and its proposed treatment of stock-option orders in a limit up-limit down state. Because Amendment No. 2 is technical in nature, it is not subject to notice and comment.

6 See Letter to Elizabeth M. Murphy, Secretary, Commission, from Angelo Evangelou, Associate General Counsel, CBOE, dated April 4, 2013 ("CBOE Letter").

7 The events of May 6 are described more fully in a joint report by the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission. See Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, "Findings Regarding the Market Events of May 6, 2010," dated September 30, 2010, available at http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

8 For further discussion on the development of the single-stock circuit breaker pilot program, see Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) ("Limit Up-Limit Down Plan" or "Plan").

to reduce extraordinary market volatility in NMS stocks by imposing a five-minute trading pause when a trade was executed at a price outside of a specified percentage threshold.[9]

To replace the single-stock circuit breaker pilot program, the equity exchanges filed a National Market System Plan[10] pursuant to Section 11A of the Act,[11] and Rule 608 thereunder,[12] which featured a "limit up-limit down" mechanism.

The Plan sets forth requirements that are designed to prevent trades in individual NMS stocks from occurring outside of the specified price bands. The price bands consist of a lower price band and an upper price band for each NMS stock. When one side of the market for an individual security is outside the applicable price band, i.e., the National Best Bid is below the Lower Price Band, or the National Best Offer is above the Upper Price band, the Processors[13] are

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[9] See Securities Exchange Act Release Nos. 62884 (September 10, 2010), 75 FR 56618 (September 16, 2010) and Securities Exchange Act Release No. 62883 (September 10, 2010), 75 FR 56608 (September 16, 2010) (SR-FINRA-2010-033) (describing the "second stage" of the single-stock circuit breaker pilot) and Securities Exchange Act Release No. 64735 (June 23, 2011), 76 FR 38243 (June 29, 2011) (describing the "third stage" of the single-stock circuit breaker pilot).

[10] NYSE Euronext filed on behalf of New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), and NYSE Arca, Inc. ("NYSE Arca"), and the parties to the proposed National Market System Plan, BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated ("CBOE") , Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, the Nasdaq Stock Market LLC, and National Stock Exchange, Inc. (collectively with NYSE, NYSE MKT, and NYSE Arca, the "Participants"). On May 14, 2012, NYSE Amex filed a proposed rule change on an immediately effective basis to change its name to NYSE MKT LLC ("NYSE MKT"). See Securities Exchange Act Release No. 67037 (May 21, 2012) (SR-NYSEAmex-2012-32).

[11] 15 U.S.C. 78k-1.

[12] 17 CFR 242.608.

[13] As used in the Plan, the Processor refers to the single plan processor responsible for the consolidation of information for an NMS Stock pursuant to Rule 603(b) of Regulation

required to disseminate such National Best Bid or National Best Offer[14] with a flag identifying that quote as non-executable. When the other side of the market reaches the applicable price band, i.e., the National Best Offer reaches the lower price band, or the National Best Bid reaches the upper price band, the market for an individual security enters a 15-second Limit State, and the Processors are required disseminate such National Best Offer or National Best Bid with an appropriate flag identifying it as a Limit State Quotation. Trading in that stock would exit the Limit State if, within 15 seconds of entering the Limit State, all Limit State Quotations were executed or canceled in their entirety. If the market does not exit a Limit State within 15 seconds, then the Primary Listing Exchange will declare a five-minute trading pause, which is applicable to all markets trading the security.

The Primary Listing Exchange may also declare a trading pause when the stock is in a Straddle State, i.e., the National Best Bid (Offer) is below (above) the Lower (Upper) Price Band and the NMS Stock is not in a Limit State. In order to declare a trading pause in this scenario, the Primary Listing Exchange must determine that trading in that stock deviates from normal trading characteristics such that declaring a trading pause would support the Plan's goal to address extraordinary market volatility.[15]

NMS under the Exchange Act. See id.

14 "National Best Bid" and "National Best Offer" has the meaning provided in Rule 600(b)(42) of Regulation NMS under the Exchange Act. See id.

15 As set forth in more detail in the Plan, all trading centers would be required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the display of offers below the Lower Price Band and bids above the Upper Price Band for an NMS Stock. The Processors would be able to disseminate an offer below the Lower Price Band or bid above the Upper Price Band that nevertheless may be inadvertently submitted despite such reasonable policies and procedures, but with an appropriate flag identifying it as non-executable; such bid or offer would not be included in National Best

On May 31, 2012, the Commission approved the Plan as a one-year pilot, which shall be implemented in two phases.[16] The first phase of the Plan shall be implemented beginning April 8, 2013.[17]

III. Description of the Proposed Rule Change, as Modified by Amendment Nos. 1 and 2

In light of and in connection with the Plan, the Exchange proposes to amend its rules to address certain option order types, order handling procedures, obvious error and market-maker quoting obligations.[18] The Exchange believes these modifications will protect investors because when an underlying security is in a limit or straddle state (collectively referred to as a "limit up-limit down state"), there will not be a reliable price for the security to serve as a benchmark for the price of the option. In addition, the Exchange believes these changes are warranted because

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Bid or National Best Offer calculations. In addition, all trading centers would be required to develop, maintain, and enforce policies and procedures reasonably designed to prevent trades at prices outside the price bands, with the exception of single-priced opening, reopening, and closing transactions on the Primary Listing Exchange.

16 See "Limit Up-Limit Down Plan," supra note 8. See also Securities Exchange Act Release No. 68953 (February 20, 2013), 78 FR 13113 (February 26, 2013) (Second Amendment to Limit Up-Limit Down Plan by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Inc., et al.) and Securities Exchange Act Release No. 69062 (March 7, 2013), 78 FR 15757 (March 12, 2013) (Third Amendment to Limit Up-Limit Down Plan by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Inc., et al.)

17 See "Second Amendment to Limit Up-Limit Down Plan," supra note 16.

18 Specifically, the Exchange proposes to make changes to Exchange Rules Rule 6.2B, "Hybrid Opening System, Rule 6.14A, "Hybrid Agency Liaison", Rule 6.25, "Nullification and Adjustment of Options Transactions," Rule 6.53, "Certain Types of Orders Defined," Rule 6.53C, "Complex Orders on the Hybrid System," Rule 8.7, "Obligations of Market-Makers, Rule 8.13, "Preferred Market-Maker Program," Rule 8.15A, "Lead Market-Maker in Hybrid Classes," Rule 8.15B, "Participation Entitlements of LLMs", Rule 8.85, "DPM Obligations," Rule 8.87, "Participation Entitlement of DPMs and e-DPMs," and Rule 8.93, "e-DPM Obligations." See Notice and Amendment No. 1.

the width of the options markets might be compromised during the limit up-limit down states and, thus, the quality of execution may be adversely impacted.

A. Exchange Rule 6.3A and the Plan

The Exchange proposes to add to Exchange Rule 6.3A to codify the changes occurring throughout its rulebook in connection with the Plan. The Exchange proposes to re-name Rule 6.3A, which is currently titled "Equity Market Trading Halt", as "Equity Market Plan to Address Extraordinary Market Volatility". The Exchange also plans to add new rule text that will define the Plan as it applies to the Exchange, and will describe the location of the other rule changes associated with the Plan. The proposed changes to Rule 6.3A will essentially serve as a roadmap for the Exchange's universal changes due to the implementation of the Plan.

B. Order Handling During the Limit Up-Limit Down State

The Exchange proposes to modify Exchange Rules 6.2B, 6.14A, 6.3A, 6.53 and 6.53C to address how certain Exchange order types will be handled when the underlying security of such orders is in a limit up-limit down state. The proposed rule change will address how market orders[19], market-on-close[20], stop orders[21], and stock option orders[22] will function on the

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19 See Exchange Rule 6.53(a) which defines a market order as "an order to buy or sell a stated number of options contracts at the best price obtainable when the order reaches the post."

20 See Exchange Rule 6.53(c)(ii) which defines a market-on-close order designation as an order "to be executed as close as possible to the closing bell, or during the closing rotation, and should be near to or at the closing price for the particular series of option contracts."

21 See Exchange Rule 6.53(c)(iii), which defines a stop order as a market order "to buy or sell when the market for a particular option contract reaches a specified price on the CBOE floor." In contrast, a stop-limit order, as defined in Exchange Rule 6.53(c)(iv), becomes a limit order when the market for the option contract reaches a specified price. CBOE does not propose to make any modifications to the treatment of stop-limit orders.

Exchange upon the implementation of the Plan. The Exchange is proposing to add language to clarify that: (a) any market order will be returned during limit up-limit down states unless it qualifies for certain exceptions;[23] (b) market-on-close orders will not be elected if the underlying security is in a limit up-limit down state[24]; (c) stop orders will not be triggered if the underlying security is in a limit up-limit down state, but will until the end of that state, at which time they will become eligible to be triggered; (d) stock-option orders will only execute if the calculated stock price is within the permissible bands.[25] In addition, if a message is sent to replace a limit order with a market order while the underlying is in a limit up-limit down state, the resting limit

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22 See Exchange Rule 6.53C(a)(2) which defines a stock-option order as "an order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock . . . coupled with the purchase or sale of options contract(s) on the opposite side of the market."

23 Specifically, a market order submitted to initiate an Automated Improvement Mechanism will be accepted. Market orders will also not be returned if the TPH elected to route that order for manual handling. With respect to market orders submitted to initiate an Automated Improvement Mechanism, the Exchange represented that such orders are entered with a contra order. Because these market orders are entered as a pair, they are effectively stopped because they must execute at a price at or better than the contra order. See Amendment No. 2. With respect to market orders routed for manual handling, the Exchange represented that those orders are physically handled by a broker on the Exchange floor who must affirmatively agree to an execution price, and that such orders are thus not subject to the same risks a market order may have if such order were to execute against unfiltered electronic prices. Id.

24 During closing rotation, the Exchange will continue to re-evaluate the state of underlying securities for which the overlying securities have not yet been closed. If upon re-evaluation the underlying security should exit a limit up-limit down state, a market-on-close order may be executed.

25 If the calculated price of a stock-option order is not within the permissible Price Bands, the stock-option order will be routed for manual handling. This provision would help ensure that a stock order would not be electronically routed to a stock venue for an execution outside of the price bands. In addition, by routing stock-option orders for manual handling, these orders will be physically handled by a broker on the Exchange floor who must affirmatively agree to an execution price. See Amendment No. 2.

order will be cancelled and the replaced market order will also be cancelled. The Exchange represented that cancelling a market order in this scenario is consistent with its treatment of market orders that are received during a limit up-limit down state, and cancelling the original limit order would be consistent with the Exchange's current cancel and replace functionality.[26]

The Exchange stated that, although it has determined to continue options trading when a stock is in a limit up-limit down state, there will not be a reliable price for the underlying security to serve as a benchmark for the price of the option. Without a reliable underlying stock price, the Exchange stated that there is an enhanced risk of errors and improper executions. The Exchange also stated that adding a level of certainty for TPHs by specifying the treatment of such orders will encourage participation on the Exchange while the underlying security is in limit up-limit down states. Accordingly, the Exchange believes these order handling changes will best protect market participants after the implementation of the Plan by not allowing execution at unreasonable prices due to the shift in the stock prices.

The Exchange also proposes to modify its opening procedures under Exchange Rule 6.2B, "Hybrid Opening System" ("HOSS"). The Exchange proposes to add an Interpretation and Policy .07 to clarify that if the underlying security for a class of options enters into a limit up-limit down state when the class moves to opening rotation, any market orders entered that trading day will be cancelled. The Exchange stated that, by cancelling the market orders, it will comply with the Plan by not allowing orders outside of the Price Bands to execute. As an exception, market orders that are considered limit orders pursuant to Rule 6.13(b)(iv) and entered the previous trading day will remain in the book. The Exchange is proposing to allow such market

[26] See Amendment No. 2.

orders to remain in the Book because these essentially act as limit orders at the minimum increment.

Next, the Exchange proposes to modify Exchange Rule 6.14A, "Hybrid Agency Liaison ("HAL"). This functionality provides automated order handling in designated classes trading on the Hybrid System for qualifying electronic orders that are not automatically executed by the Hybrid System.[27] When the Exchange receives a qualifying order that is marketable against the National Best Bid or Offer ("NBBO") and/or the Exchange's best bid or offer ("BBO"),[28] HAL electronically exposes the order[29] at the NBBO price to allow Market-Makers appointed in that class, as well as all Trading Permit Holders ("TPHs") acting as agent for orders, at the top of the Exchange's book in the relevant series (or all TPHs if allowed by the Exchange) to step up to the NBBO price.

The Exchange proposes to amend Rule 6.14A to modify the functioning of HAL with respect to market orders when the underlying security of the option is in a limit up-limit down state. Under the proposal, if an underlying security enters a limit up-limit down state while a market order is being exposed through HAL, the auction will end early, i.e., upon the entering of the limit up-limit down state. Additionally, any unexecuted portion of the market order would be

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27 Currently, the Exchange determines the eligible order size, eligible order types, eligible origin code (i.e., public customer orders, non-Market-Maker broker-dealer orders and Market-Maker broker-dealer orders), and classes in which HAL is activated. See Exchange Rule 6.14A(a).

28 HAL will not electronically expose the order if the Exchange's quotation contains resting orders and does not contain sufficient Market-Maker quotation interest to satisfy the entire order.

29 The duration of the exposure period may not exceed one second. See Exchange Rule 6.14A(c) (describing the manner in which an exposed order is allocated under HAL); see also Exchange Rule 6.14A(d) (listing the circumstances in which an exposure period would terminate early).

cancelled. The Exchange stated that because there is an uncertainty of market prices during a limit up-limit down state, terminating the HAL auction early and cancelling the market order will ensure that market orders do not receive an unanticipated price.[30] As such, the proposed rule changes would protect market participants by ensuring that they do not receive an executed order with an unanticipated price due to the change in the underlying security.

The Exchange also proposes to modify the treatment of complex orders on the Hybrid System and the Complex Order Auction ("COA") process. Generally, on a class-by-class basis, the Exchange may activate COA, which is a process by which eligible complex orders[31] are given an opportunity for price improvement before being booked in the electronic complex order book ("COB") or on a PAR workstation. Upon receipt of a COA-eligible order and a request from a TPH representing the order that such order be subjected to a COA, the Exchange will send a request for responses ("RFR") message to all TPHs who have elected to receive RFR messages.[32] Each Market-Maker with an appointment in the relevant option class and each TPH

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30 See Amendment No. 1.

31 An eligible complex order, referred to in Rule 6.53C as a "COA-eligible order," means a complex order that, as determined by the Exchange on a class-by-class basis, is eligible for a COA considering the order's marketability (defined as a number of ticks away from the current market), size, complex order type and complex order origin type (i.e., non-broker-dealer public customer, broker-dealers that are not Market-Makers or specialists on an options exchange, and/or Market-Makers or specialists on an options exchange). All determinations by the Exchange on COA-eligible order parameters are announced to Trading Permit Holders by Regulatory Circular. See Rule 6.53C(d)(i)(2) and Interpretation and Policy .01 to Rule 6.53C.

32 See Exchange Rule 6.53C(d)(ii). The RFR message will identify the component series, the size of the COA-eligible order and any contingencies, but will not identify the side of the market.

acting as agent for orders resting at the top of the COB in the relevant options series may then submit responses to the RFR message during the Response Time Interval.[33]

The Exchange proposes to add to the COA rule that if, during COA of a market order, the underlying security of an option enters a limit up-limit down state, the COA will end upon the entering of that state and the remaining portion of the order, if a market order, will cancel. The Exchange believes this change will best protect investors because, once the underlying enters a limit up-limit down state, pricing in the options markets may change, resulting in executions at unexpected prices.

C. Market Maker Obligations and Participation Entitlements

The Exchange proposes to eliminate all market maker obligations for options in which the underlying security is in a limit up-limit down state. Currently, Exchange Rules 8.7, 8.13, 8.15A, 8.85, and 8.93 impose certain obligations on Market-Makers[34], PMMs[35], LMMs[36],

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33 See Exchange Rule 6.53C(d)(iii). A "Response Time Interval" means the period of time during which responses to the RFR may be entered, the length of which is determined by the Exchange on a class-by-class basis but may not exceed three seconds. See Rule 6.53C(d)(iii)(2).

34 See Exchange Rule 8.1, which defines a "Market-Maker" as "an individual Trading Permit Holder or a TPH organization that is registered with the Exchange for the purpose of making transactions as a dealer specialist on the Exchange . . . ."

35 See Exchange Rule 8.13, which defines a "Preferred Market-Maker" as a specific Market-Maker designated by a Trading Permit Holder to receive that Trading Permit Holder's orders in a specific class.

36 See Exchange Rule 8.15A, which defines a "Lead Market-Maker" as a Market-Maker in good standing appointed by the Exchange "in an option class for which a DPM has not been appointed . . . ."

DPMs[37], and e-DPMs[38], respectively, including obligations to provide continuous electronic quotes.

The Exchange proposes to eliminate all market maker quoting obligations[39] in series of options when the underlying security is currently in a limit up-limit down state. According to the Exchange, eliminating all Market Maker obligations in connection with the implementation of the Plan is the most effective way to ensure the options markets will not be compromised when the underlying security enters a limit up-limit down state. Specifically, there may not be reliable prices for an underlying security during a limit up-limit down state. Additionally, it may be difficult or not possible for a market participant to hedge the purchase or sale of an option if the bid or offer of an underlying security may not be executable due to a limit up-limit down state. Given the possible effects of the limit up-limit down state, the Exchange anticipates that Exchange Market-Makers may be forced to change behaviors during these periods. In an effort to protect the investors in the options market while the underlying security is in a limit up-limit down state, the Exchange believes that eliminating quoting obligations is the more effective way for this protection.

Although the Exchange is proposing to relieve market makers of their quoting obligations when the underlying is in a limit up-limit down state, the Exchange is proposing that PMMs, LMMs, DPMs and e-DPMs may still receive participation entitlements pursuant to the proposed

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37 See Exchange Rule 8.80, which defines a "Designated Primary Market-Maker" as a "TPH organization that is approved by the Exchange to function in allocated securities as a Market-Maker . . . and is subject to the obligations under Rule 8.85 . . . ."

38 See Exchange Rule 8.92, which defines an "Electronic DPM" as a "TPH Organization that is approved by the Exchange to remotely function in allocated option classes as a DPM and to fulfill certain obligations required of DPMs . . . ."

39 See Notice, supra note 3.

rules in all series in their assigned classes in which they are quoting, even in series in which they are not required to provide continuous electronic quotes under the Exchange Rules. The Exchange stated that market makers already receive participation entitlements in series in which they are not required to quote; thus, under the proposed rule change, the market would continue to function as it does now with respect to how entitlements are allocated to Market-Makers. The Exchange believes this benefit is appropriate, as it incentivizes Market-Makers to quote in as many series as possible in their appointed classes, even those series in which the underlying security has entered into a limit up-limit down state. The Exchange stated that it is attempting to better encourage Market-Makers to quote even though they will not have the obligation. If market makers do choose to quote, the Exchange believes they should be entitled to receive the entitlement for such quoting as appropriate.

D. Nullification and Adjustment of Options Transactions

In connection with the implementation of the Plan, the Exchange proposes to adopt Interpretation and Policies .06 to Rule 6.25 to exclude transactions in options that overlay a security during a Limit State or Straddle State from the obvious error pricing provision in Rule 6.25(a)(1) for a one year pilot basis from the date of adoption of the proposed rule change. Additionally, the Exchange proposes to specify that electronic transactions in options that overlay an NMS stock that occur during a Limit State or Straddle State may be reviewed on an Exchange motion pursuant to Rule 6.25(b)(3). The Exchange also proposes to provide the Commission with data and analysis during the duration of the pilot as requested.

Under Rule 6.25, an Obvious Price Error occurs when the execution price of an electronic transaction is above or below the theoretical price for the series by a specified amount. Pursuant to Rule 6.25(a)(1)(i), the theoretical price of an option series is currently defined, for series traded on at least one other options exchange, as the last national best bid price with respect to an erroneous sell transaction, and the last national best offer price with respect to an erroneous buy transaction, just prior to the trade. In certain circumstances, Trading Officials have the discretion to determine the theoretical price pursuant to Rule 6.25(a)(1)(iv).[40]

The Exchange believes that neither method is appropriate during a Limit State or Straddle State. In Amendment No. 1, the Exchange noted that during a Limit State or Straddle State, options prices may deviate substantially from those available prior to or following the state. The Exchange believes this provision would give rise to much uncertainty for market participants as there is no bright line definition of what the theoretical value should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. The Exchange noted that determining theoretical value in such a situation would be often times be very subjective rather than an objective determination and would give rise to additional uncertainty and confusion for investors. Similarly, the Exchange believes the application of the current rule would be impracticable given the lack of a reliable national best bid or offer in the options market during Limit States and Straddle States, and would produce undesirable effects.

Ultimately, the Exchange believes that adding certainty to the execution of limit orders in these situations should encourage market participants to continue to provide liquidity to the Exchange, thus promoting a fair and orderly market. On balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit

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40 Rule 6.25(a)(1)(iv) provides there are no quotes for comparison, or if the bid/ask differential of the national best bid and offer for the affected series just prior to the erroneous transaction was at least two times the permitted bid/ask differential determined by the Exchange, designated Trading Officials will determine the theoretical price.

States or Straddle States outweighs any potential benefits from applying these provisions during such unusual market conditions.

Therefore, the Exchange proposes to adopt Interpretation and Policy .06 to Rule 6.25 to provide that transactions executed during a Limit State or Straddle State are not subject to the obvious pricing error provision in Rule 6.25(a)(1). In addition, amended Rule 6.25 will include a qualification that nothing in the proposed rule change will prevent transactions in options that overlay a security in a Limit State or Straddle State from being reviewed on an Exchange motion pursuant to Rule 6.25(b)(3). According to the Exchange, this safeguard will provide the flexibility to act when necessary and appropriate, while also providing market participants with certainty that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. The right to review on Exchange motion electronic transactions that occur during a Limit State or Straddle State under this provision, according to the Exchange, would enable the Exchange to account for unforeseen circumstances that result in obvious or catastrophic errors for which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors. The Exchange also proposes to provide the Commission with data and analysis during the duration of the pilot as requested.

IV. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities exchange.[41] In particular, the Commission finds that the proposed rule change is

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41 In approving the proposed rule changes, the Commission has considered their impact on

consistent with Section 6(b)(5) of the Act,[42] which, among other things, requires a national securities exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange, and is 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 regulation, 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 general, to protect investors and the public interest.

A. Exchange Rule 6.3A and the Plan

Exchange Rule 6.3A lists changes to Exchange order types, order handling, obvious error, and market-maker quoting obligations that the Exchange is making in connection with the implementation of the Plan. The Exchange believes that the proposed changes to Rule 6.3A will describe to TPHs and other market participants where to find the changes associated with the Plan's implementation. Accordingly, the Commission finds that this change promotes clarity in connection with CBOE's proposed changes in response to the Limit up-Limit Down Plan and is therefore consistent with the Act.

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efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

42 15 U.S.C. 78f(b).

B. Order Handling During the Limit Up-Limit Down State

As detailed above, the Exchange proposes to add language to clarify that: (a) market orders, with certain exceptions, will be returned during limit up-limit down states, (b) market-on-close orders will not be elected if the underlying security is in a limit up-limit down state, (c) stop orders will not be triggered while the underlying security is in a limit up-limit down state, and (d) stock-option orders will only execute if the calculated stock price is within the permissible bands, unless such order is routed for manual handling. In addition, during a limit up-limit down state, if a message is sent to replace a limit order with a market order, the resting limit order will be cancelled and the replaced market order will also be cancelled.

The Commission finds that the Exchange's proposed method of handling such orders is consistent with Section 6(b)(5) of the Act. When the underlying stock enters a limit up-limit down state, the lack of a reliable price in that market could affect the options markets in various ways, including wider spreads and less liquidity. This could potentially mean that market orders, which contain no restrictions on the price at which they may execute, could receive executions at unintended prices if executed during the limit up-limit down state. As such, the proposed changes to reject market orders and market-on-close orders if the underlying is in a limit up-limit down state, to not trigger stop orders if the underlying is in a limit up-limit down state, and to cancel market orders that replace limit orders when the underlying is in a limit up-limit down state, are reasonably designed to prevent such orders from being executed at potentially unexpected prices.

At the same time, the proposed exceptions to the treatment of these orders – accepting market orders that are submitted to initiate an Automated Price Improvement Mechanism, or which are routed for manual handling – are designed to take into account that market orders submitted in these ways may not be at the same risk as other market orders for executions at unexpected prices. Specifically, market orders submitted through the Automated Price Improvement Mechanism are submitted as pairs, and are effectively stopped because they must execute at a price at or better than the contra order. With respect to market orders routed for manual handling, such orders are physically handled by a broker on the Exchange floor who must affirmatively agree to an execution price, as opposed to simply executing that order against electronic prices. Similarly, the Exchange's proposal to route a stock-option order for manual handling when the underlying is in a limit up-limit down state allows such orders to be physically handled by a broker on the Exchange floor who must affirmatively agree to an execution price.

The Exchange proposes to add an Interpretation and Policy .07 to Rule 6.2B which states that if the underlying security for a class of options enters into a limit up-limit down state when the class moves to opening rotation, any market orders entered that trading day will be cancelled. However, market orders that are considered limit orders pursuant to Rule 6.13(b)(iv) and entered the previous trading day will remain in the Book and can essentially act as limit orders at the minimum increment.

The Commission finds that these changes are consistent with the Act in that they are reasonably designed to counter potential price dislocations that may occur if the underlying enters a limit up-limit down state during the opening by preventing market orders, which contain no restrictions on the price at which they may execute, from being executed at potentially unintended prices. At the same time, this proposal allows market orders that are essentially limit orders to continue to participate in the opening process without a similar risk of an execution at an unintended price.

The Exchange also proposes that, if an underlying security enters a limit up-limit down state while a market order is being exposed through HAL, the auction will end early, and any unexecuted portion of the market order would be cancelled. The Commission believes that this provision will provide certainty to options market participants on how market orders submitted to HAL will be handled during limit up-limit down states. In addition, the Commission finds that this provision is consistent with the Act in that it is reasonably designed to counter potential price dislocations that may occur if the underlying enters a limit up-limit down state while the HAL functionality is underway by preventing market orders, which contain no restrictions on the price at which they may execute, from being executed at potentially unintended prices.

The Exchange proposes to amend the COA rule so that, if during a COA of a market order, the underlying security of an option enters a limit up-limit down state, the COA will end and the remaining portion of the order, if a market order, will cancel. As with the proposed change to HAL, the Commission believes that this provision is consistent with the Act in that it will provide certainty to options market participants on how market orders submitted to COA will be handled during limit up-limit down states. In addition, the Commission finds that this provision is reasonably designed to counter potential price dislocations that may occur if the underlying enters a limit up-limit down state while a COA is underway by preventing market orders, which contain no restrictions on the price at which they may execute, from being executed at potentially unintended prices.

C. Market Maker Obligations

The Commission finds that the proposal to suspend a market maker's obligations when the underlying security is in a limit up-limit down state is consistent with the Act. During a limit up-limit down state, there may not be a reliable price for the underlying security to serve as a benchmark for market makers to price options. In addition, the absence of an executable bid or offer for the underlying security will make it more difficult for market makers to hedge the purchase or sale of an option. Given these significant changes to the normal operating conditions of market makers, the Commission finds that the Exchange's decision to suspend a market maker's obligations in these limited circumstances is consistent with the Act. The Commission notes, however, that the Plan was approved on a pilot basis and its Participants will monitor how it is functioning in the equity markets during the pilot period. To this end, the Commission expects that, upon implementation of the Plan, the Exchange will continue monitoring the quoting requirements that are being amended in this proposed rule change and determine if any necessary adjustments are required to ensure that they remain consistent with the Act.

The Commission also finds that the proposal to maintain participation entitlements for market makers in all series in their assigned classes in which they are quoting, including in series for which the underlying security is in a limit up-limit down state and for which they are not required to provide continuous electronic quotes under the Exchange Rules, is consistent with the Act. To the extent that market makers are only eligible for participation entitlements if they are quoting at the best price on the Exchange, this proposal is reasonably designed to incentivize Market-Makers to quote more aggressively when the underlying security has entered into a limit up-limit down state than they might otherwise quote, potentially providing additional liquidity and price discovery. To the extent that, under this proposal, market makers would receive participation entitlements in series in which they are not required to quote, the Commission notes that this aspect of the proposal is consistent with the current application of participation entitlements.

D. Nullification and Adjustment of Options Transactions

The Commission finds that the Exchange's proposal to suspend certain aspects of Rule 6.25 during a Limit State or Straddle State is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[43] in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

In Amendment No. 1, the Exchange notes its belief that suspending certain aspects of Rule 6.25 during a Limit State or Straddle State will ensure that limit orders that are filled during a Limit or Straddle State will have certainty of execution in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. The Exchange believes the application of the current rule would be impracticable given what it perceives will be the lack of a reliable NBBO in the options market during Limit States and Straddle States, and that the resulting actions (i.e.,

43 15 U.S.C. 78f(b)(5).

nullified trades or adjusted prices) may not be appropriate given market conditions. In addition, given the Exchange's view that options prices during Limit States or Straddle States may deviate substantially from those available shortly following the Limit State or Straddle State, the Exchange believes that providing market participants time to re-evaluate a transaction executed during a Limit State or Straddle State will create an unreasonable adverse selection opportunity that will discourage participants from providing liquidity during Limit States or Straddle States. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange during Limit States and Straddle States, thus promoting fair and orderly markets.

The Exchange, however, has proposed this rule change based on its expectations about the quality of the options market during Limit States and Straddle States. The Exchange states, for example, that it believes that application of the obvious and catastrophic error rules would be impracticable given the potential for lack of a reliable NBBO in the options market during Limit States and Straddle States. Given the Exchange's recognition of the potential for unreliable NBBOs in the options markets during Limit States and Straddle States, the Commission is concerned about the extent to which investors may rely to their detriment on the quality of quotations and price discovery in the options markets during these periods. This concern is heightened by the Exchange's proposal to exclude electronic trades that occur during a Limit State or Straddle State from the obvious pricing error provisions of Rule 6.25(a)(1) and the nullification or adjustment provisions of Rule 6.25. The Commission urges investors and market professionals to exercise caution when considering trading options under these circumstances. Broker-dealers also should be mindful of their obligations to customers that may or may not be aware of specific options market conditions or the underlying stock market conditions when placing their orders.

While the Commission remains concerned about the quality of the options market during the Limit States and Straddle States, and the potential impact on investors of executing in this market without the protections of the obvious or catastrophic error rules that are being suspended during the Limit and Straddle States, it believes that certain aspects of the proposal could help mitigate those concerns.

First, despite the removal of obvious and catastrophic error protection during Limit States and Straddle States, the Exchange states that there are additional measures in place designed to protect investors. For example, the Exchange states in Amendment No. 1 that by rejecting market orders and not electing stop orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Additionally, the Exchange notes the existence of SEC Rule 15c3-5 requiring broker-dealers to have controls and procedures in place that are reasonably designed to prevent the entry of erroneous orders. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying certain provisions during such unusual market conditions.

The Exchange also believes that the aspect of the proposed rule change that will continue to allow the Exchange to review on its own motion electronic trades that occur during a Limit State or a Straddle State is consistent with the Act because it would provide flexibility for the Exchange to act when necessary and appropriate to nullify or adjust a transaction and will enable the Exchange to account for unforeseen circumstances that result in obvious errors for which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors. The Exchange represents that it will administer this provision in a manner that is consistent with the principles of the Act. In addition, the Exchange has represented that it will create and maintain records relating to the use of the authority to act on its own motion during a Limit State or Straddle State.

Finally, the Exchange has proposed that the changes be implemented on a one year pilot basis. The Commission believes that it is important to implement the proposal as a pilot. The one year pilot period will allow the Exchange time to assess the impact of the Plan on the options marketplace and allow the Commission to further evaluate the effect of the proposal prior to any proposal or determination to make the changes permanent. To this end, the Exchange has committed to: (1) evaluate the options market quality during Limit States and Straddle States; (2) assess the character of incoming order flow and transactions during Limit States and Straddle States; and (3) review any complaints from members and their customers concerning executions during Limit States and Straddle States. Additionally, the Exchange has agreed to provide the Commission with data requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above. On April 4, 2013, the Exchange submitted a letter stating that it would provide specific data to the Commission and the public and certain analysis to the Commission to evaluate the impact of Limit States and Straddle States on liquidity and market quality in the options markets.[44] This will allow the Commission,

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[44] In particular, the Exchange represented that, at least two months prior to the end of the one year pilot period of proposed Interpretation and Policy .06 to Rule 6.25, it would provide to the Commission an evaluation of (i) the statistical and economic impact of Straddle States on liquidity and market quality in the options market and (ii) whether the lack of obvious error rules in effect during the Limit States and Straddle States are

the Exchange, and other interested parties to evaluate the quality of the options markets during Limit States and Straddle States and to assess whether the additional protections noted by the Exchange are sufficient safeguards against the submission of erroneous trades, and whether the Exchange's proposal appropriately balances the protection afforded to an erroneous order sender against the potential hazards associated with providing market participants additional time to review trades submitted during a Limit State or Straddle State.

In addition, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act[45] for approving the proposed rule change on an accelerated basis. This proposal is related to the Plan, which will become operative on April 8, 2013, and aspects of the proposal, such as

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problematic. In addition, the Exchange represented that each month following the adoption of the proposed rule change it would provide to the Commission and the public a dataset containing certain data elements for each Limit State and Straddle State in optionable stocks. The Exchange stated that the options included in the dataset will be those that meet the following conditions: (i) the options are more than 20% in the money (strike price remains greater than 80% of the last stock trade price for calls and strike price remains greater than 120% of the last stock trade price for puts when the Limit State or Straddle State is reached); (ii) the option has at least two trades during the Limit State or Straddle State; and (iii) the top ten options (as ranked by overall contract volume on that day) meeting the conditions listed above. For each of those options affected, each dataset will include, among other information: stock symbol, option symbol, time at the start of the Limit State or Straddle State and an indicator for whether it is a Limit State or Straddle State. For activity on the exchange in the relevant options, the Exchange has agreed to provide executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer, high execution price, low execution price, number of trades for which a request for review for error was received during Straddle States and Limit States, an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit State or Straddle State compared to the last available option price as reported by OPRA before the start of the Limit or Straddle state (1 if observe 30% and 0 otherwise), and another indicator variable for whether the option price within five minutes of the underlying stock leaving the Limit State or Straddle State (or halt if applicable) is 30% away from the price before the start of the Limit State or Straddle state. See CBOE Letter, supra note 6.

[45] 15 U.S.C. 78s(b)(2)

rejecting market orders and not electing Stop Orders during a limit up-limit down state, are designed to prevent such orders from receiving poor executions during those times. In granting accelerated approval, the proposed rule change, and its corresponding protections, will take effect upon the Plan's implementation date. Accordingly, the Commission finds that good cause exists for approving the proposed rule change on an accelerated basis.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[46] that the proposed rule change (SR-CBOE-2013-030), as modified by Amendments Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[47]

Kevin M. O'Neill
Deputy Secretary

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46 15 U.S.C. 78s(b)(2).

47 17 CFR 200.30-3(a)(12).