SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52577; File No. SR-CBOE-2005-60)

October 7, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto Relating to an Automated Improvement Mechanism

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on August 5, 2005, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the CBOE. On September 2, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend its rules to adopt an electronic price improvement mechanism. Below is the text of the proposed rule change. Proposed new language is italicized.

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

2 17 CFR 240.19-4.

3 Amendment No. 1 superseded and replaced the proposed rule filing in its entirety.

* * * * *

**Chicago Board Options Exchange, Incorporated**
**Rules**

* * * * *

**Rule 6.74A Automated Improvement Mechanism ("AIM")**

Notwithstanding the provisions of Rule 6.74, a member that represents agency orders may electronically execute an order it represents as agent ("Agency Order") against principal interest or against a solicited order provided it submits the Agency Order for electronic execution into the AIM auction ("Auction") pursuant to this Rule.

(a) Auction Eligibility Requirements. A member (the "Initiating Member") may initiate an Auction provided all of the following are met:

(1) the Agency Order is in a class designated as eligible for AIM Auctions as determined by the appropriate Floor Procedure Committee and within the designated Auction order eligibility size parameters as such size parameters are determined by the appropriate Floor Procedure Committee;

(2) if the Agency Order is for 50 contracts or more, the Initiating member must stop the entire Agency Order as principal or with a solicited order at the better of the NBBO or the Agency Order's limit price (if the order is a limit order);

(3) if the Agency Order is for less than 50 contracts, the Initiating member must stop the entire Agency Order as principal or with a solicited order at the better of (A) the NBBO price improved by one minimum price improvement increment, which increment shall be determined by the Exchange but may not be smaller than one cent; or (B) the Agency Order's limit price (if the order is a limit order); and

(4) at least three (3) Market-Makers are quoting in the relevant series.

(b) Auction Process. Only one Auction may be ongoing at any given time in a series and Auctions in the same series may not queue or overlap in any manner. The Auction may not be cancelled and shall proceed as follows:

(1) Auction Period and Request for Responses (RFRs).

(A) To initiate the Auction, the Initiating Member must mark the Agency Order for Auction processing, and specify (i) a single price at which it seeks to cross the Agency Order (with principal interest or a solicited order) (a "single-price submission"), or (ii) that it is willing to automatically match as principal the price and size of all Auction responses ("auto-match") in which case the Agency Order will be stopped at the NBBO (if 50 contracts or greater) or one cent/one minimum increment better than the NBBO (if less than 50 contracts). Once the Initiating

Member has submitted an Agency Order for processing pursuant to this subparagraph, such submission may not be modified or cancelled.

(B) When the Exchange receives a properly designated Agency Order for Auction processing, a Request for Responses ("RFR") detailing the side and size of the order will be sent to all members that have elected to receive RFRs.

(C) The RFR will last for a random time period determined by the system that shall not be less than 3 seconds and shall not exceed 5 seconds.

(D) Each Market-Maker with an appointment in the relevant option class may submit responses to the RFR (specifying prices and sizes). Such responses cannot cross the disseminated Exchange quote on the opposite side of the market.

(E) Floor Brokers may submit responses to the RFR (specifying prices and sizes) only on behalf of orders resting at the top of the Exchange's book (resting at the BBO) opposite the Agency Order. Such responses cannot cross the disseminated Exchange quote on the opposite side of the market, and may not exceed the size of the booked order being represented.

(F) RFR responses shall not be visible to other Auction participants, and shall not be disseminated to OPRA.

(G) The minimum price increment for RFR responses and for an Initiating Member's single price submission shall not be smaller than the minimum price improvement increment established pursuant to subparagraph (a)(3)(A) above.

(H) An RFR response size at any given price point may not exceed the size of the Agency Order.

(I) RFR responses may be modified or cancelled.

(2) Conclusion of Auction. The Auction shall conclude at the sooner of (A) through (E) below with the Agency Order executing pursuant to paragraph (3) below.

(A) The end of the RFR period;

(B) Upon receipt by the Hybrid System of an unrelated order (in the same series as the Agency Order) that is marketable against either the Exchange's disseminated quote (when such quote is the NBBO) or the RFR responses;

(C) Upon receipt by the Hybrid System of an unrelated limit order (in the same series as the Agency Order and on the opposite side of the market as the Agency Order) that improves any RFR response;

(D) Any time an RFR response matches the Exchange's disseminated quote on the opposite side of the market from the RFR responses; or

(E) Any time there is a quote lock on the Exchange pursuant to Rule 6.45A(d).

(3) Order Allocation. At the conclusion of the Auction, the Agency Order will be allocated at the best price(s) pursuant to the matching algorithm in effect for the class subject to the following:

(A) Such best prices may include non-Auction quotes and orders.

(B) Public customer orders in the book shall have priority.

(C) No participation entitlement shall apply to orders executed pursuant to this Rule.

(D) If an unrelated market or marketable limit order on the opposite side of the market as the Agency Order was received during the Auction and ended the Auction, such unrelated order shall trade against the Agency Order at the midpoint of the best RFR response and the NBBO on the other side of the market from the RFR responses (rounded towards the disseminated quote when necessary).

(E) If an unrelated non-marketable limit order on the opposite side of the market as the Agency Order was received during the Auction and ended the Auction, such unrelated order shall trade against the Agency Order at the midpoint of the best RFR response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary).

(F) If the best price equals the Initiating Member's single-price submission, the Initiating Member's single-price submission shall be allocated the greater of one contract or 40% of the order. However, if only one Market-Maker matches the Initiating Member's single price submission then the Initiating Member shall be allocated 50% of the order.

(G) If the Initiating Member selected the auto-match option of the Auction, the Initiating Member shall be allocated its full size at each price point until a price point is reached where the balance of the order can be fully executed. At such price point, the Initiating Member shall be allocated the greater of one contract or 40% of the remainder of the order.

(H) If the Auction does not result in price improvement over the Exchange's disseminated price at the time the Auction began, resting unchanged quotes or orders that were disseminated at the best price before the Auction began shall have priority after any public customer order priority and the Initiating Member's priority (40%) have been satisfied. Any unexecuted balance on the Agency Order shall be allocated to RFR responses provided that those RFR responses will be capped to the size of the unexecuted balance and that the Initiating Member may not participate on any such balance unless the Agency Order would otherwise go unfilled.

(I) If the final Auction price locks a customer order in the book on the same side of the market as the Agency Order, then, unless there is sufficient size in the Auction responses to execute both the Agency Order and the booked customer order (in which case they will both execute at the final Auction price), the Agency Order will execute against the RFR responses at one minimum RFR response increment worse than the final Auction price against the Auction participants that submitted the final Auction price and any balance shall trade against the customer order in the book at such order's limit price.

If an unexecuted balance remains on the Auction responses after the Agency Order has been executed and such balance could trade against any unrelated order(s) that caused the Auction to conclude, then the RFR balance will trade against the unrelated order(s).

***…Interpretations and Policies:***

**.01** The Auction may be used only where there is a genuine intention to execute a bona fide transaction.

**.02** A pattern or practice of submitting unrelated orders that cause an Auction to conclude before the end of the RFR period will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1. It will also be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 to engage in a pattern of conduct where the Initiating Member breaks-up an Agency Order into separate orders for two (2) or fewer contracts for the purpose of gaining a higher allocation percentage than the Initiating Member would have otherwise received in accordance with the allocation procedures contained in subparagraph (b)(3) above.

**.03** Initially, and for at least a Pilot Period expiring on July 18, 2006, there will be no minimum size requirement for orders to be eligible for the Auction. During this Pilot Period, the Exchange will submit certain data, periodically as required by the Commission, to provide supporting evidence that, among other things, there is meaningful competition for all size orders and that there is an active and liquid market functioning on the Exchange outside of the Auction mechanism. Any data which is submitted to the Commission will be provided on a confidential basis.

**.04** Any solicited orders submitted by the Initiating Member to trade against the Agency Order may not be for the account of a Market-Maker assigned to the option class.

**.05** Any determinations made by the Exchange pursuant to this Rule such as eligible classes, order size parameters and the minimum price increment for RFR responses shall be communicated in a Regulatory Circular.

**.06** Subparagraph (b)(2)(E) of this rule will be effective for a Pilot Period until July 18, 2006. During the Pilot Period, the Exchange will submit certain data relating to the frequency with which early termination of the Auction occurs pursuant to this provision as well as any other provision, and also the frequency with which early termination pursuant to this provision results in favorable pricing for the Agency Order.

* * * * *

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

In its filing with the Commission, CBOE 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 these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

The Exchange proposes to establish an Automated Improvement Mechanism ("AIM") that would electronically auction certain orders for price improvement. Under the AIM process, a member ("Initiating Member") that represents agency orders may submit an order it represents as agent ("Agency Order") along with a second order (a principal order or a solicited order for the same amount as the Agency Order) into the AIM auction where other participants could compete with the Initiating Member's second order to execute against the Agency Order.

When submitting an Agency Order into the AIM auction, the Initiating Member must also submit a contra-side second order for the same size as the Agency Order. This second order guarantees that the Agency Order will receive an execution (i.e., it acts as a stop).[4] Once an AIM

[4] In connection with the stop of the Agency Order, the following shall apply: if (1) the Agency Order is for less than 50 contracts, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of (A) the national best bid or offer ("NBBO") price improved by one minimum price improvement increment,

auction has commenced, it cannot be cancelled by the Initiating Member. The Initiating Member may enter the second order in one of two formats: (1) a specified single price, or (2) a non-price specific commitment to match as principal the price and size of all auction responses that are received during the auction. In this case, the Initiating Member would have no control over the match price.

Upon receipt of an Agency Order (and second order), the Exchange would commence the AIM auction by issuing a request for responses ("RFR") detailing the side and size of the Agency Order.[5] The RFR response period (i.e., the auction) would last for a random time period (calculated by the Exchange system) that shall not be less than 3 seconds and shall not exceed 5 seconds. During that period any Market-Maker with an appointment in the class as well as any Floor Broker on behalf of orders resting at the top of the Exchange's book opposite the Agency Order may submit RFR responses (including multiple responses). These responses must specify price and size and may not cross the Exchange's quote on the opposite side of the market. All RFR responses are "blind," that is, they are not visible to any other participants. CBOE believes this aspect of the auction will encourage more aggressive quoting and superior price improvement. RFR responses may be modified or cancelled so long as they are modified or cancelled before the conclusion of the random RFR response period. Lastly, the RFR response minimum price increment may be set by the Exchange at no less than one cent.

---

which increment shall be determined by the Exchange but may not be smaller than one cent; or (B) the Agency Order's limit price (if the order is a limit order); and (2) if the Agency Order is for 50 contracts or more, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of the NBBO or the Agency Order's limit price (if the order is a limit order).

[5] Each RFR would be sent to all members electing to receive RFRs (i.e., those members who have established the necessary systems connectivity to receive RFRs). Thus, such election to receive RFRs would not be on a case-by-case basis. Only members specified in proposed CBOE Rule 6.74A(b)(1)(D) and (E) may submit responses.

Normally, the auction ends at the conclusion of the random RFR response timer (3 to 5 seconds),[6] however, the proposal provides that certain other events would end the auction prior to the conclusion of the RFR timer. These events are: (1) receipt by the Hybrid System of an unrelated order, in the same series as the Agency Order, that is marketable against the Exchange's disseminated quote (when such quote is the NBBO) or the RFR responses, (2) receipt by the Hybrid System of an unrelated non-marketable limit order, in the same series as the Agency Order and on the opposite side of the market as the Agency Order, that improves any RFR response, (3) any time an RFR response matches the Exchange's disseminated quote on the opposite side of the market, and (4) pursuant to a pilot program that will expire on July 18, 2006, any time there is a Market-Maker to Market-Maker quote lock on the Exchange (in accordance with CBOE Rule 6.45A(d)).[7]

At the conclusion of the auction, the Agency Order would be allocated in accordance with applicable matching algorithm rules in effect for such class subject to the following provisions. First, no participation entitlement would apply with respect to an AIM execution. Second, public customer orders in the book would have priority. Third, if an unrelated market order or marketable limit order on the opposite side of the market as the Agency Order was received during the auction and ended the auction, such unrelated order would trade against the Agency Order at the midpoint of the best RFR response and the NBBO on the other side of the

---

6 CBOE represents that this random time period would be determined solely by the Exchange system.

7 In connection with this pilot program, the Exchange would provide the Commission data (on a confidential basis) regarding the frequency with which early termination of the Auction occurs pursuant to this provision as well as any other provision, and also the frequency with which early termination pursuant to this provision results in favorable pricing for the Agency Order. Proposed Interpretation .06 to Proposed CBOE Rule 6.74A.

market (rounded towards the disseminated quote when necessary).[8] Fourth, if an unrelated non-marketable limit order on the opposite side of the market as the Agency Order was received during the auction and ended the auction, such unrelated limit order would trade against the Agency Order at the midpoint of the best RFR response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary).[9] Fifth, if the best price equals the Initiating Member's single-price submission, the Initiating Member's single-price submission would be allocated the greater of one contract or 40% of the order. However, if only one Market-Maker matches the Initiating Member's single price submission then the Initiating Member would be allocated 50% of the order. Sixth, if the Initiating Member selected the auto-match option of the auction, the Initiating Member would be allocated its full size at each price point until a price point is reached where the balance of the order can be fully executed. At such price point, the Initiating Member would be allocated the greater of one contract or 40% of the remainder of the order. Seventh, if the auction does not result in price improvement over the Exchange's disseminated price at the time the auction began, resting unchanged quotes or orders that were disseminated at the best price before the auction began would have priority after any public customer order priority and the Initiating Member's priority (40%) have been satisfied. Any unexecuted balance on the Agency Order would be allocated to RFR responses pursuant to the matching algorithm except that the responses would be capped to the size of the unexecuted

8 For example, if an AIM auction is underway for an Agency Order to buy and the CBOE quote (as well as the NBBO) is 1 - 1.15 with the RFR responses at 1.12 and an unrelated market order to sell is received by the Exchange, the unrelated order would execute against the Agency Order at 1.06 (the midpoint of the best RFR responses and the NBBO).

9 For example, using the same scenario as above except the unrelated order is a non-marketable limit order to sell at 1.10, the unrelated order would execute against the Agency Order at 1.11 (the midpoint of the best RFR responses and the unrelated order's limit price).

balance and the Initiating Member may not participate on any such balance unless the Agency Order would otherwise go unfilled. Eight, if the final auction price locks a customer order in the book on the same side of the market as the Agency Order, then, unless there is sufficient size in the auction responses to execute both the Agency Order and the booked customer order (in which case they will both execute at the final auction price), the Agency Order would execute against the RFR responses at one minimum RFR response increment worse than the final Auction price against the auction participants that submitted the final auction price and any balance would trade against the customer order in the book at such order's limit price.

If an unexecuted balance remains on the auction responses after the Agency Order has been executed and such balance could trade against any unrelated order(s) that caused the Auction to conclude, then the RFR balance would trade against the unrelated order(s). CBOE believes this is a benefit to the market in that excess auction liquidity would be available to orders other than the Agency Order.

Lastly, the Exchange proposes certain interpretations and policies. First, the auction may be used only where there is a genuine intention to execute a bona fide transaction. Second, a pattern or practice of submitting unrelated orders that cause an auction to conclude before the end of the RFR period would be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1 and other Exchange Rules. Third, initially, and for at least a Pilot Period expiring on July 18, 2006, there would be no minimum size requirement for orders to be eligible for the auction. During this Pilot Period, the Exchange would submit certain data, periodically as required by the Commission, to provide supporting evidence that, among other things, there is meaningful competition for all size orders and that there is an active and liquid market functioning on the Exchange outside of the Auction mechanism. Any data which is submitted to the Commission would be provided on a confidential basis. Fourth, any solicited orders submitted by the Initiating Member to trade against the Agency Order may not be for the account of a Market-Maker assigned to the option class. Fifth, any determinations made by the Exchange pursuant to the proposed rule such as eligible classes, order size parameters and the minimum price increment for RFR responses would be communicated in a Regulatory Circular. Finally, proposed CBOE Rule 6.74A(b)(2)(E), which would end the auction because of a lock on the CBOE market, would operate as a pilot program until July 18, 2006.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act[10] in general and furthers the objectives of Section 6(b)(5) of the Act[11] in particular in that it is designed to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, the Exchange believes that the proposal would provide an opportunity for customers to receive price improvement on their orders.

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

This proposed rule change does not impose any burden on competition that is 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

No written comments were solicited or received with respect to the proposed rule change.

---

[10] 15 U.S.C. 78f(b).

[11] 15 U.S.C. 78f(b)(5).

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

Within 35 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 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, as amended, 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. Please include File Number SR-CBOE-2005-60 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2005-60. 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 Web site (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 inspection and copying in the Commission's Public Reference Room. 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-2005-60 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Jonathan G. Katz
Secretary

---

[12] 17 CFR 200.30–3(a)(12).