

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53101; File No. SR-CBOE-2006-03)

January 11, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Expand the Matching Algorithm Possibilities for Equity Options to Match those Available for Index Options

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 January 9, 2006, 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 and II below, which Items have been prepared by the CBOE. The Exchange has filed the proposal pursuant to Section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to expand the matching algorithm possibilities for equity options to match those available for index options. The Exchange has designated this proposal as non-controversial and has requested that the Commission waive the 30-day pre-operative waiting period contained in Rule 19b-4(f)(6)(iii) under the Act.⁵

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ 17 CFR 240.19b-4(f)(6)(iii).

The text of the proposed rule change is available on the Exchange's Web site (<http://www.cboe.com>), at the principal office of the Exchange, and at the Commission's Public Reference Room. The text of the proposed rule change is also set forth below. Proposed new language is underlined; deletions are in [brackets].

Rule 6.45A. Priority and Allocation of Equity Option Trades on the CBOE Hybrid System

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(a) Allocation of Incoming Electronic Orders: [The Exchange shall apply, for each class of options, the following rules of trading priority.] The appropriate Exchange procedures committee will determine to apply, for each class of options, one of the following rules of trading priority described in paragraphs (i) or (ii). The Exchange will issue a Regulatory Circular periodically specifying which priority rules will govern which classes of options any time the appropriate Exchange committee changes the priority.

(i) Ultimate Matching Algorithm ("UMA"): No change.

(A) Priority of Orders in the Electronic Book – No Change.

(ii) Price-Time or Pro-Rata Priority

Price-Time Priority: Under this method, resting quotes and orders in the book are prioritized according to price and time. If there are two or more quotes or orders at the best price then priority is afforded among these quotes or orders in the order in which they were received by the Hybrid System; or

Pro-Rata Priority: Under this method, resting quotes and orders in the book are prioritized according to price. If there are two or more quotes or orders at the best price then trades are allocated proportionally according to size (in a pro-rata fashion). The executable quantity is allocated to the nearest whole number, with fractions 1/2 or greater

rounded up and fractions less than 1/2 rounded down. If there are two market participants that both are entitled to an additional 1/2 contract and there is only one contract remaining to be distributed, the additional contract will be distributed to the market participant whose quote or order has time priority.

Additional Priority Overlays Applicable to Price-Time or Pro-Rata Priority Methods

In addition to the base allocation methodologies set forth above, the appropriate Exchange procedures committee may determine to apply, on a class-by-class basis, one or more of the following designated market participant overlay priorities in a sequence determined by the appropriate Exchange procedures committee. The Exchange will issue a Regulatory Circular periodically which will specify which classes of options are subject to these additional priorities as well as any time the appropriate Exchange procedures committee changes these priorities.

(1) Public Customer: When this priority overlay is in effect, the highest bid and lowest offer shall have priority except that public customer orders shall have priority over non-public customer orders at the same price. If there are two or more public customer orders for the same options series at the same price, priority shall be afforded to such public customer orders in the sequence in which they are received by the System, even if the Pro-Rata Priority allocation method is the chosen allocation method. For purposes of this Rule, a Public Customer order is an order for an account in which no member, non-member participant in a joint-venture with a member, or non-member broker-dealer (including a foreign broker-dealer) has an interest.

(2) Participation Entitlement: The appropriate Exchange procedures committee may determine to grant Market-Makers participation entitlements pursuant to

the provisions of Rules 8.87, 8.13, or 8.15B. In allocating the participation entitlement, all of the following shall apply:

(A) To be entitled to their participation entitlement, the Market-Maker's order and/or quote must be at the best price on the Exchange.

(B) The Market-Maker may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price. If Pro-Rata Priority is in effect, and Market-Maker's allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted, the Market-Maker shall not receive any further allocation of that order.

(C) In establishing the counterparties to a particular trade, the participation entitlement must first be counted against that Market-Maker's highest priority bids or offers.

(D) The participation entitlement shall not be in effect unless the Public Customer priority is in effect in a priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance.

(3) Market Turner: "Market Turner" means a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order (quote) is continuously in the market until the particular order (quote) trades. There may be a Market Turner for each price at which a particular order trades. When this priority overlay is in effect, the Market Turner has priority at the highest bid or lowest offer that he established. The Market Turner priority at a given price remains with

the order (quote) once it is earned. For example, if the market moves in the same direction as the direction in which the order from the Market Turner moved the market, and then the market moves back to the Market Turner's original price, then the Market Turner retains priority at the original price. Market Turner priority cannot be established until after the opening print and/or the conclusion of the opening rotation and, once established, shall remain in effect until the conclusion of the trading session.

The appropriate Exchange procedures committee may determine, on a class-by-class basis, to reduce the Market Turner priority to a percentage of each inbound order that is executable against the Market Turner. In such cases, the Market Turner may participate in the balance of an order, pursuant to the allocation procedure in effect, after the Market Turner priority has been applied. To the extent the Market Turner order (quote) is not fully exhausted, it shall retain Market Turner priority for subsequent inbound orders until the conclusion of the trading session.

(b) Allocation of Orders Represented in Open Outcry: The allocation of orders that are represented in open outcry by floor brokers or PAR Officials shall be as described below in subparagraphs (b)(i) and (b)(ii). With respect to subparagraph (b)(ii), the floor broker or PAR Official representing the order shall determine the sequence in which bids (offers) are made.

(i) Priority of Orders in the Electronic Book

(A) Public Customer Orders: No change.

(B) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate FPC determines to allow broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer orders in the electronic

book at the best price shall be deemed one "book market participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "book market participant" shall be in accordance with paragraph (ii) below and shall be distributed among each broker-dealer order comprising the "book market participant" in accordance with the Allocation Algorithm formula in effect pursuant to Rule 6.45A(a) [described in paragraph 6.45A(a)(i)(B)].

(ii) - (iv) No change.

(c) - (e) No change.

. . . Interpretations and Policies:

.01 - .02 No change.

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Rule 6.45B Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System

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(a) No change.

(b) Allocation of Orders Represented in Open Outcry: The allocation of orders that are represented in the trading crowd by floor brokers or PAR Officials shall be as described below in subparagraphs (b)(i) and (b)(ii). With respect to subparagraph (b)(ii), the floor broker or PAR Official representing the order shall determine the sequence in which bids (offers) are made.

(i) Priority of Orders in the Electronic Book

(A) Public Customer Orders: No change.

(B) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate Exchange procedures committee determines to allow broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer orders in the electronic book at the best price shall be deemed one "book market participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "book market participant" shall be in accordance with paragraph (ii) below and shall be distributed among each broker-dealer order comprising the "book market participant" in accordance with the Allocation Algorithm formula in effect pursuant to Rule 6.45B(a) [described in paragraph 6.45B(a)(ii)(B)].

(ii) - (iii) No change.

(c) - (d) No change.

. . . Interpretations and Policies:

.01 - .02 No change.

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

In its filing with the Commission, the Exchange 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 Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant parts of such statements.

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

1. Purpose

CBOE Rule 6.45A sets forth, among other things, the manner in which electronic Hybrid trades in equity options are allocated. Paragraph (a) of CBOE Rule 6.45A essentially governs how orders received electronically by the Exchange are electronically executed against interest in the CBOE quote. Paragraph (a) of CBOE Rule 6.45A currently provides that such electronic trades be allocated pursuant to a matching algorithm called the Ultimate Matching Algorithm (“UMA”). CBOE Rule 6.45B establishes the manner in which electronic Hybrid trades in Index options and options on exchange traded funds (“ETFs”) are allocated.⁶ Unlike CBOE Rule 6.45A, which is applicable to equity options (which essentially requires UMA for all electronic Hybrid equity option trading), CBOE Rule 6.45B provides a “menu” of matching algorithms to choose from for each product traded pursuant to that rule. That menu includes UMA as well as price-time priority and pro-rata priority matching scheme (with several optional priority overlays). The menu format allows the Exchange to utilize different matching algorithms by product.

The Exchange states that the purpose of the proposed rule change is to adopt a menu for equity option trading by carrying over the matching options available under CBOE Rules 6.45B(a) to 6.45A(a). The Exchange states that this will enable the Exchange to utilize price-time priority or pro-rata priority (along with the optional market turner priority,⁷ customer priority, and participation entitlement priority overlays) for equity option trading. As proposed,

⁶ For details on that rule, see Securities Exchange Release No. 51822 (June 10, 2005), 70 FR 35321 (June 17, 2005) (SR-CBOE-2004-87).

⁷ For information on market-turner priority, see Securities Exchange Release No. 52659 (October 24, 2005), 70 FR 62149 (October 28, 2005) (SR-CBOE-2005-85).

these “new” matching algorithms are identical to the matching algorithms available to index and ETF options. Thus, the Exchange states that there are no new types of matching algorithms being proposed herein, and this proposed rule change would merely expand the products that can use these other priority allocation algorithms.

Moreover, the proposed rule change also proposes a minor change to the open outcry section of the Hybrid trading rules (CBOE Rule 6.45A(b) for equity options and CBOE Rule 6.45B(b) for index options) to ensure they are consistent with whichever electronic matching algorithm is in place pursuant to paragraph (a) of both rules. More specifically, paragraph (b) of both rules governs how orders represented in open outcry interact with interest resting in the Hybrid quote. The Exchange states that broker-dealer orders resting in that quote at the execution price are deemed one “book market participant” for purposes of determining how many contracts should be allocated to the broker-dealers orders collectively. Once that determination has been made however, the allocation of those contracts between the broker-dealer orders is handled systematically. Currently, the rules provide that the UMA formula is used to systematically distribute the contracts between those orders (that is because UMA is the only available algorithm for equity options under CBOE Rule 6.45A). However, the system is programmed to allocate those contracts between those broker-dealer orders using whichever matching algorithm is in place for electronic executions for the subject option class under paragraph (a) of both rules (which under the “menu” structure could be matching algorithms other than UMA). As proposed, CBOE Rule 6.45A(b) as well as CBOE Rule 6.45B(b) would be modified to reflect that possibility.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the

Act⁸ in general, and furthers the objectives of Section 6(b)(5) of the Act⁹ in particular, in that the rules of an exchange be designed to promote just and equitable principles of trade, and to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will result in 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

Written comments were neither solicited nor received.

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

The foregoing proposed rule change is subject to Section 19(b)(3)(A)(iii) of the Act¹⁰ and Rule 19b-4(f)(6) thereunder¹¹ because the proposal: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative prior to 30 days after the date of filing or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the Exchange has given the Commission notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

The CBOE has satisfied the five-day pre-filing requirements. In addition, the Exchange has requested that the Commission waive the 30-day operative delay. The Commission notes

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ 15 U.S.C. 78s(b)(3)(A)(iii).

¹¹ 17 CFR 240.19b-4(f)(6).

that this proposal would provide equity option products with a similar menu of priority allocation methodologies currently available for index option products (such as price-time, pro-rata, and several optional priority overlays). Thus, the Commission believes that there is no new regulatory issues herein such that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The waiver will permit the Exchange to implement the proposed rule change without delay and thereby providing additional priority allocation options to equity option trading on the Exchange. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.¹²

At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act.¹³

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-03 on the subject line.

¹² For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹³ See Section 19(b)(3)(C) of the Act, 15 U.S.C. 78s(b)(3)(C).

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2006-03. 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 the filing also will be available for inspection and copying at the principal office of the CBOE. 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-2006-03 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.¹⁴

Nancy M. Morris
Secretary

¹⁴ 17 CFR 200.30-3(a)(12).