

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54422; File No. SR-CBOE-2004-21)

September 11, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Establish Rules for a Screen-Based Trading System for Non-Option Securities

I. Introduction

On April 14, 2004, the 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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to adopt on a pilot basis rules governing the trading of non-option securities on an electronic platform known as “STOC.” The Exchange filed Amendment No. 1 with the Commission on January 11, 2006.<sup>3</sup> The amended proposal was published for comment in the Federal Register on January 23, 2006.<sup>4</sup> The Commission received no comments on the proposal. The Exchange filed Amendment No. 2 with the Commission on August 3, 2006.<sup>5</sup> This notice and order requests comment on Amendment No. 2 and approves the proposal, as amended, on an accelerated basis.

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

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

<sup>3</sup> Amendment No. 1 replaced the original filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 53112 (January 12, 2006), 71 FR 3579.

<sup>5</sup> In Amendment No. 2, a partial amendment, the Exchange, among other things, revised proposed CBOE Rule 52.1 to require that the public customer priority overlay be activated whenever pro rata priority is in use; removed provisions relating to complex orders; revised the requirements for executing a facilitation or crossing transaction with priority over existing interest on the book; and made additional non-substantive changes to the proposed rule text.

## II. Description of the Proposal

### A. Overview of the STOC System

CBOE currently trades a small number of non-option securities.<sup>6</sup> These products are not traded on CBOE's options trading platform, but rather on a stand-alone platform in an open-outcry environment pursuant to Chapter XXX (30) of CBOE's rules. In 2003, the Commission approved Chapters XL (40) through XLVI (46) of CBOE's rules, which established a purely screen-based trading platform for trading options on the Exchange called "CBOEdirect."<sup>7</sup> Components of that system have been adapted to create CBOE's Hybrid Trading System (currently in use for options trading), to facilitate the trading of single-stock futures by OneChicago, and to trade security futures products on the CBOE Futures Exchange. CBOE now proposes to use the CBOEdirect platform to trade non-option securities in a purely electronic environment that would replace its existing system. All products currently traded under Chapter 30 would migrate to the new platform and trade pursuant to new Chapters 50-55. The new platform is called "Stock Trading on CBOEdirect" ("STOC" or "STOC System"). Like CBOEdirect, STOC would: (1) be entirely screen-based; (2) utilize a DPM/LMM-driven model with optional supplemental liquidity provided by market makers; (3) utilize a configurable matching algorithm based on either price-time or pro rata priority, with optional priority overlays; and (4) integrate all quotes and orders entered into the system into the STOC book.

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<sup>6</sup> As of August 3, 2006, CBOE traded two such products. See Amendment No. 2.

<sup>7</sup> See Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (approving SR-CBOE-00-55) ("CBOEdirect Approval Order"). However, at this time, CBOE does not trade options pursuant to Chapters 40-46.

B. Market Participants

1. STOC Market Makers

A STOC market maker is a member registered with the Exchange for the purpose of making transactions as a dealer in the STOC System. A STOC market maker may be either a STOC standard market maker, a STOC designated primary market maker (“STOC DPM”), or a STOC lead market maker (“STOC LMM”).<sup>8</sup> A member seeking to register as a STOC market maker must file a written application with the Exchange’s Membership Department, which may approve or disapprove the registration.<sup>9</sup> A registered STOC market maker may apply for an appointment in one or more non-option securities traded on the STOC System. The appropriate Market Performance Committee may arrange two or more securities into groupings and make appointments to those groupings rather than to individual securities. The appropriate Market Performance Committee may suspend or terminate any appointment of a STOC market maker or make additional appointments whenever, in the committee’s judgment, the interests of a fair and orderly market would best be served by such action.<sup>10</sup>

With respect to each non-option security for which it holds an appointment, a STOC market maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity or a temporary disparity between supply and demand in a particular security. A STOC market maker is expected to perform the following activities in the course of maintaining a fair and orderly market in all securities in which it holds an appointment:

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<sup>8</sup> See CBOE Rule 53.20.

<sup>9</sup> See CBOE Rule 53.21(a).

<sup>10</sup> See CBOE Rule 53.22(a).

- competing with other STOC market makers to improve markets;
- making markets which, absent changed market conditions, will be honored for the number of shares entered into the STOC System; and
- updating market quotations in response to changed market conditions.<sup>11</sup>

In addition, at least 75% of a STOC market maker's total dollar amount transacted on the STOC System must be in securities to which it has an appointment.<sup>12</sup>

Furthermore, a STOC market maker is required to respond to a certain percentage of requests for quotes ("RFQs") that it receives. The appropriate Market Performance Committee has the authority to determine the percentage of RFQs to which a STOC market maker must respond, which percentage may not be less than 75%.<sup>13</sup> A STOC market maker would be credited for an RFQ response only if: (1) it responds to the RFQ with a two-sided market within a time period designated by the appropriate Market Performance Committee; (2) the quote size is at least equal to the minimum size specified by the appropriate Market Performance Committee; and (3) the STOC market maker provides a continuous market for 30 seconds, or the quote is filled before the 30-second period expires.<sup>14</sup> The STOC market maker could change its quote during this period but could not cancel it and still receive credit for the response.<sup>15</sup>

A STOC market maker could be a STOC designated primary market maker ("STOC DPM") or a STOC lead market maker ("STOC LMM"). The Exchange's STOC DPM Committee may assign a STOC DPM to a particular security.<sup>16</sup> If the STOC DPM Committee

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<sup>11</sup> See CBOE Rule 53.23(a)(1).

<sup>12</sup> See CBOE Rule 53.23(a)(2)(A).

<sup>13</sup> See CBOE Rule 53.23(b).

<sup>14</sup> See id.

<sup>15</sup> See id.

<sup>16</sup> See CBOE Rule 53.50.

does not appoint a STOC DPM in a given security, the appropriate Market Performance Committee could appoint one or more STOC LMMs.<sup>17</sup> If more than one STOC LMM is appointed, each would function as the STOC LMM on a rotating basis in accordance with a schedule set by the appropriate Market Performance Committee.<sup>18</sup> STOC LMMs would have responsibilities similar to STOC DPMs.<sup>19</sup>

The obligations of STOC DPMs and STOC LMMs are greater than those of STOC standard market makers.<sup>20</sup> STOC DPMs and STOC LMMs are obligated, for example, to provide opening quotes and continuous quotes for all their allocated securities.<sup>21</sup> Furthermore, STOC DPMs and STOC LMMs are required to handle public customer orders that are not executed on the system due to there being a better quote on another exchange, and to accord priority to public customer orders over their own principal transactions (unless the person who placed the order has consented to not being accorded such priority).<sup>22</sup>

## 2. STOC Brokers

A STOC broker is an individual (either a member or a nominee of a member organization) who is registered with the Exchange for the purpose of accepting and executing on the STOC System orders received from members, broker-dealers, or public customers. As with brokers operating in the Exchange's open-outcry market, a STOC broker would not be permitted to accept an order from any source other than a member or a registered broker-dealer, unless he

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<sup>17</sup> See CBOE Rule 53.51.

<sup>18</sup> See id.

<sup>19</sup> See id.

<sup>20</sup> See CBOE Rule 50.3(a).

<sup>21</sup> See CBOE Rule 53.56(a)(2) and (4).

<sup>22</sup> See CBOE Rule 53.56(b)(6).

or she were approved to transact business with the public in accordance with CBOE Rule 9.1.<sup>23</sup>

An applicant for registration as a STOC broker must file his or her application in writing with the Exchange's Membership Department, which shall consider an applicant's ability as demonstrated by passing an examination prescribed by the Exchange and such other factors as the committee deems appropriate. After reviewing the application, the committee may either approve or disapprove the applicant's registration as a STOC broker.<sup>24</sup>

### 3. Clearing Firm Brokers

A clearing firm broker is an individual who represents the clearing firm of a particular STOC market maker and has the authority to take certain actions with respect to that STOC market maker's use of the STOC System.<sup>25</sup> A clearing firm broker may request the CBOE Help Desk to force the logout of a STOC trader when, for example, that trader has financial difficulty. In addition, the forced logout of a STOC trader could be necessary if technical difficulties prevented the trader from logging off on his or her own.

#### C. States of Operation

The STOC System rules define five states of operation: pre-opening, opening, trading, trading halt, and closed.

Pre-opening is some period of time, as determined by the Exchange, prior to the opening during which the STOC System will accept orders and quotes, but no trading will take place.<sup>26</sup>

During the opening, STOC will accept orders and quotes for inclusion in the opening trade for a period of time determined by the Exchange. At the end of that period, quotes and

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<sup>23</sup> See CBOE Rule 53.60.

<sup>24</sup> See CBOE Rule 53.61(a).

<sup>25</sup> See CBOE Rule 53.70(a).

<sup>26</sup> See CBOE Rule 51.3(a).

orders will continue to be accepted for some period of time, but will not be included in the opening trade.<sup>27</sup> Opening prices are established by one of two methods, depending on whether the Exchange is the primary market for the security. If the Exchange were the primary market, STOC would open that security at the price that provides the highest matched quantity of order volume.<sup>28</sup> If the Exchange were not the primary market, the STOC DPM/LMM would open the security at a single price that matches the primary market or at a price that does not trade through another exchange's quote.<sup>29</sup> At the end of the opening, STOC will complete the opening trades, if any.<sup>30</sup>

During trading, securities will trade freely and orders and quotes will be accepted.<sup>31</sup>

Exchange Trading Officials have the power to order a trading halt on STOC if there are unusual market conditions.<sup>32</sup> During a trading halt, orders continue to be accepted by the STOC System but would not be executed.<sup>33</sup> Upon termination of the halt, any halted security would go through the pre-opening and opening procedures before STOC began regular trading again.

The STOC System will close at a time predetermined by the Exchange, consistent with its rule regarding days and hours of business.<sup>34</sup> Trading is stopped but STOC will continue to accept certain types of orders and allows STOC traders to maintain their orders. At some

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<sup>27</sup> See CBOE Rule 51.3(b).

<sup>28</sup> See CBOE Rule 52.2(a).

<sup>29</sup> See CBOE Rule 52.2(b).

<sup>30</sup> See CBOE Rule 51.3(b).

<sup>31</sup> See CBOE Rule 51.3(c).

<sup>32</sup> See CBOE Rule 52.3. In addition, existing CBOE Rule 6.3B (Trading Halts Due to Extraordinary Market Volatility) provides that the Exchange shall halt trading in all securities whenever a market-wide trading halt, commonly known as a circuit breaker, is initiated on the New York Stock Exchange in response to extraordinary market conditions.

<sup>33</sup> See CBOE Rule 51.3(d).

<sup>34</sup> See CBOE Rules 51.3(b) and 51.2.

designated time, as determined by the Exchange, STOC will cease accepting orders and perform its end-of-day procedures.<sup>35</sup>

D. Priority

The STOC rules do not prescribe a single allocation methodology. Instead, the appropriate STOC Trading Committee has the authority to apply to each non-option security traded on STOC one of various allocation priorities.<sup>36</sup> CBOE represents that it would issue a regulatory circular specifying the allocation rules that would govern each non-option security traded on STOC.<sup>37</sup>

1. Basic Allocation Methodologies

There would be two basic types of trade allocation methodologies:

a. Price-Time Priority. Under this method, resting orders in the STOC book would be prioritized according to price and time. If two or more orders were at the best price, priority among these orders would be afforded in the sequence in which they were received by the STOC System.<sup>38</sup>

b. Pro Rata Priority. Under this method, resting orders in the STOC book would be prioritized according to price. If there were two or more orders at the best price,

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<sup>35</sup> See CBOE Rule 51.6. The STOC System's end-of-day procedures include deleting orders that expire at the end of that session, such as day orders, session orders, and expiring good-'til-cancelled orders. See id.

<sup>36</sup> See CBOE Rule 52.1(a).

<sup>37</sup> See Amendment No. 2.

<sup>38</sup> See CBOE Rule 52.1(a)(1).



public customer orders would be executed first,<sup>39</sup> and any remaining size would be allocated to the non-public customers at the best price proportionally according to order size.<sup>40</sup>

## 2. Additional Priority Overlays

In addition to these allocation methodologies, the appropriate STOC Trading Committee could determine to overlay, on a security-by-security basis, any or all of the following additional “priority overlays.”<sup>41</sup>

a. Public Customer. If this were the only priority overlay in effect, the highest bid and lowest offer would have priority, except that a public customer order would have priority over a non-public customer order at the same price. If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate STOC Trading Committee. In either case, if there were two or more public customer orders at the same price, priority would be afforded to these orders in the sequence in which they were received by the STOC System, even if the pro rata allocation method were the designated allocation method. For purposes of this provision, a “public customer order” is an order for an account in which no CBOE member, non-member participant in a joint venture with a member, or non-member broker-dealer (including a foreign broker-dealer) has an interest.<sup>42</sup>

b. Market Turner. The “market turner” is the STOC trader who is the first to enter an order or quote at a price better than the previous best price, provided the order or

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<sup>39</sup> The rule governing the pro rata priority matching algorithm requires that any time the pro rata priority is in effect, the public customer priority overlay of CBOE Rule 52.1(b)(1) also be in effect. See CBOE Rule 52.1(a)(2), as amended by Amendment No. 2.

<sup>40</sup> The executable quantity would be allocated to the nearest whole number, with fractions 1/2 or greater rounded up and fractions less than 1/2 rounded down. If there were two STOC traders that were both entitled to an additional 1/2 share, the additional share would be distributed to the STOC trader whose quote or order had time priority. See id.

<sup>41</sup> See CBOE Rule 52.1(b).

<sup>42</sup> See CBOE Rule 52.1(b)(1).

quote is continuously in the market until it trades.<sup>43</sup> If market turner priority were the only priority overlay in effect, the market turner would have priority at the highest bid or lowest offer that it had established. If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate STOC Trading Committee. In either case, market turner priority at a given price would remain with the order once it had been earned. For example, if the market moved in the same direction as the market turner had moved the market, and the market moves back to the market turner's original price, the market turner would retain priority at the original price.<sup>44</sup>

c. Trade Participation Right. STOC DPMs and STOC LMMs may be granted a trade participation right to trade against up to 40% of an incoming order at a given price, even though the order and/or quote of the STOC DPM/LMM did not have the highest time priority at that price.<sup>45</sup> If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate STOC Trading Committee. The following conditions would apply to the STOC DPM/LMM trade participation right:

- To be entitled to a participation right, the order and/or quote of the STOC DPM/LMM must be at the best price.<sup>46</sup>

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<sup>43</sup> See CBOE Rule 50.1(g).

<sup>44</sup> See CBOE Rule 52.1(b)(2).

<sup>45</sup> See CBOE Rules 52.1(b), 53.51, and 53.57. However, the participation of a STOC DPM/LMM in an order may exceed 40%, depending on the allocation rules in effect. Assume, for example, that price-time priority is in effect. A STOC DPM/LMM could receive up to 40% of an incoming order due to its trade participation right, then receive an additional portion of the incoming order if it has an order or quote on the STOC book with the highest time priority at the best price. If pro rata priority were in effect, a STOC DPM/LMM could receive up to 40% of an incoming order due to its trade participation right, then receive an additional portion of the incoming order if its percentage of the total volume being quoted at the best price exceeds 40%.

<sup>46</sup> See CBOE Rule 52.1(b)(3)(A).

- A STOC DPM/LMM may not be allocated a total quantity greater than the quantity than it is quoting at that price. If pro rata priority is in effect and the STOC DPM/LMM's allocation of an order pursuant to its trade participation right is greater than its percentage share of the quotes/orders at the best price at the time that the trade participation right is granted, the STOC DPM/LMM may not receive any further allocation of that order.<sup>47</sup>
- The trade participation right may not be in effect unless the public customer priority is in effect and is ahead of the trade participation right in the priority sequence.<sup>48</sup> Thus, public customer orders at the best price would be executed before any STOC DPM/LMM quote/order(s) pursuant to the trade participation right.
- If the trade participation right priority overlay and the market turner priority overlay are both in effect and the STOC DPM/LMM is the market turner, market turner priority would not apply.<sup>49</sup>
- If price-time priority is in effect and the STOC DPM/LMM has a quote and one or more orders at the same price, any shares executed as part of the STOC DPM/LMM's trade participation right would trade with the highest priority quote/order(s) of the STOC DPM/LMM.<sup>50</sup>

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<sup>47</sup> See CBOE Rule 52.1(b)(3)(B).

<sup>48</sup> See CBOE Rule 52.1(b)(3)(C).

<sup>49</sup> See CBOE Rule 52.1(b)(3)(D).

<sup>50</sup> See CBOE Rule 52.1(b)(3)(E).

- If other priority overlays are in effect and designated as higher priorities than the trade participation right, the participation right would apply only to any remaining balance of an order after all higher priorities were satisfied.<sup>51</sup>

### 3. Automatic Quote Regeneration

STOC eventually will allow a STOC market maker to have the system automatically regenerate its quote where the bid or offer to be regenerated is a defined number of ticks worse than the bid or offer that had been hit.<sup>52</sup> The market maker would pre-set the system with the number of ticks worse by which its quote would regenerate.<sup>53</sup>

If a STOC market maker has the system regenerate its quote and the regenerated quote could immediately execute against the same incoming order that traded against the original quote, that portion of the regenerated quote equal to the original size executed against the market maker's original bid or offer would take priority over all other interest at the regenerated price, with respect to the balance of the incoming order, except in one circumstance. That circumstance would be if public customer priority were applicable in that security and there were a public customer order at the same price as the regenerated bid or offer. The portion of a regenerated quote that is not executed would be placed in a priority position consistent with the time that the quote was regenerated.<sup>54</sup>

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<sup>51</sup> See CBOE Rule 52.1(b)(3)(F).

<sup>52</sup> See CBOE Rule 53.24(b).

<sup>53</sup> See id.

<sup>54</sup> See CBOE Rule 52.1(d).

E. Order Processing and Execution

1. Market Orders

STOC will automatically match a market order against the order at the best price in the STOC book and against other orders behind the best price at varying prices until the market order is fully executed or until an execution would result in a trade-through of another exchange's quotation at a non-exempted price pursuant to the ITS Plan ("trade-through price").<sup>55</sup> STOC will not automatically execute a market order in an ITS-eligible security at a price inferior to the trade-through price. Instead, the order would be displayed to STOC traders at a price equal to the national best bid or offer ("NBBO") for a period of time determined by the STOC Trading Committee, but in any event not to exceed three seconds. If the order is not executed during this display period, it would route to the STOC DPM/LLM for routing to the NBBO market or execution at the trade-through price.<sup>56</sup>

2. Limit Orders

Upon entry into STOC, a marketable limit order will be matched against the best prices available in the STOC book under the allocation methodology and priority overlays then in effect. STOC will not automatically execute a marketable limit order at a price inferior to the trade-through price. Instead, such order would be displayed to STOC traders at the limit price for a period of time determined by the STOC Trading Committee, but in any event not to exceed three seconds. After such time, the limit order would route to the STOC DPM/LMM for routing to the NBBO market or execution at the trade-through price.<sup>57</sup>

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<sup>55</sup> See CBOE Rule 52.6(a).

<sup>56</sup> See id.

<sup>57</sup> See CBOE Rule 52.7.

If the limit order is not marketable when it is entered, the STOC book will hold and display the limit order so that it may trade against later submitted orders.<sup>58</sup>

3. Odd-Lot Orders

A STOC market maker shall execute a market odd-lot order at the best price being quoted by such market maker on the STOC System, provided that such quote matches the NBBO. When the best quote on the STOC System does not match the NBBO, an odd-lot order would route to the STOC DPM/LMM for execution. All odd-lot market orders entered prior to the opening will automatically receive the opening price.<sup>59</sup>

An odd-lot limit order shall be maintained by the STOC System until it: (1) becomes marketable against the STOC DPM/LMM quote; or (2) a trade occurs on any exchange at the limit price. In either case, the limit order shall execute against the STOC DPM/LMM at the limit price.<sup>60</sup>

4. ITS Commitments

Upon entry of an ITS commitment into STOC, the system will attempt to match it against the best prices available in the STOC book under the allocation methodology and priority overlays then in effect. If there were no orders or quotes in the STOC book that matched the limit price of the ITS commitment, the system would display the ITS commitment to STOC traders at the limit price for a period of time determined by the STOC Trading Committee, but in any event not to exceed three seconds. If the ITS commitment is not executed at the conclusion

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<sup>58</sup> See id.

<sup>59</sup> See CBOE Rule 52.8.

<sup>60</sup> See id.

of that period, it would be canceled by the STOC System. An inbound market ITS commitment would be executed at the NBBO or canceled.<sup>61</sup>

5. Types of Orders Handled

At the discretion of the appropriate STOC Trading Committee, and once the STOC System is so enabled, any of the following order types may be accommodated on the system: market orders, limit orders, cancel orders, cancel replace orders, day orders, good-'til-canceled orders, scale orders, sell "plus" orders, buy "minus" orders, switch order-contingent orders, time orders, odd-lot orders, and contingency orders.<sup>62</sup> The types of contingency orders contemplated by the STOC rules are opening-only orders, all-or-none orders, fill-or-kill orders, immediate-or-cancel orders, minimum volume orders, stop (stop-loss) orders, stop-limit orders, and market-on-close orders.<sup>63</sup>

F. Other Trading Rules

1. Clearly Erroneous Trades

The STOC rules provide that the terms of a transaction executed on the system are "clearly erroneous" when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.<sup>64</sup> A member that is a party to an erroneous execution, either for its own or for a customer's account, may request the Exchange to review the transaction. The request for review should be made immediately via telephone, with a written follow-up within 15 minutes of execution. Once the request has been received, an officer of the Exchange designated by the President shall review the transaction under dispute

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<sup>61</sup> See CBOE Rule 52.10.

<sup>62</sup> See CBOE Rule 51.8.

<sup>63</sup> See CBOE Rule 51.8(g).

<sup>64</sup> See CBOE Rule 52.4(a).

and determine whether it is clearly erroneous, with a view toward maintaining a fair and orderly market and the protection of investors and the public interest.<sup>65</sup>

If the officer determines that the transaction in dispute is clearly erroneous, the officer shall declare the transaction null and void or modify one or more of the terms of the transaction to achieve an equitable rectification of the error that would place the parties in the same position, or as close as possible to the same position, that they would have been in had the error not occurred. The officer shall promptly notify the parties of the determination reached and shall also issue a written resolution of the matter.<sup>66</sup> The member aggrieved by the officer's determination may appeal such determination in accordance with the Exchange's rules for hearings on and review of Exchange decisions.<sup>67</sup>

## 2. Facilitation and Crossing of Orders

A STOC trader that wishes to cross two original orders or to facilitate an original order may do so at the established bid or offer, irrespective of existing interest on the STOC book, provided the transaction: (1) is for at least 5,000 shares; (2) is for a principal amount of at least \$100,000; and (3) is greater in size than any single public customer order resting on the STOC book at the proposed cross price.<sup>68</sup>

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<sup>65</sup> See CBOE Rule 52.4(b).

<sup>66</sup> See CBOE Rule 52.4(c).

<sup>67</sup> See CBOE Rules, Chapter 19.

<sup>68</sup> See CBOE Rule 52.11, as amended by Amendment No. 2. CBOE has confirmed that nothing in Rule 52.11 would permit a STOC trader to execute a trade in an ITS-eligible security at a price that would result in a trade-through of another ITS market's quote. See Amendment No. 2.



### 3. Firm Quote Obligations

Each responsible broker or dealer, as defined in Rule 600(b)(65) of Regulation NMS under the Act,<sup>69</sup> must communicate to the Exchange its bids and offers in accordance with Rule 602(b)(1) of Regulation NMS,<sup>70</sup> and a bid or offer submitted by a responsible broker or dealer must be firm pursuant to Rule 602(b)(2) of Regulation NMS<sup>71</sup> as to both price and size, subject to certain exceptions:<sup>72</sup>

- the level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the security in a manner that accurately reflects the current state of the market on the Exchange and, as a result, the market in the security is declared to be “non-firm”;<sup>73</sup>
- a system malfunction or other circumstance impairs the Exchange’s ability to disseminate or update quotes in a timely and accurate manner; or
- any of the circumstances set forth in Rule 602(c)(3) of Regulation NMS<sup>74</sup> exists.

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<sup>69</sup> 17 CFR 242.600(b)(65).

<sup>70</sup> 17 CFR 242.602(b)(1).

<sup>71</sup> 17 CFR 242.602(b)(2).

<sup>72</sup> See CBOE Rule 52.13(b).

<sup>73</sup> See CBOE Rule 52.13(a) regarding the designation of a market as “non-firm.”

<sup>74</sup> 17 CFR 242.602(b)(3).

#### 4. Side-By-Side Trading and Integrated Market Making

The STOC rules permit side-by-side trading<sup>75</sup> and integrated market making<sup>76</sup> in limited circumstances consistent with those that the Commission has approved for other trading systems, including CBOE’s existing equity trading rules.<sup>77</sup> The STOC rules would permit side-by-side trading and integrated market making for market participants that trade options on ETFs and TIRs that are broad-based, highly capitalized, and liquid (as measured by criteria set forth in the proposed rules).<sup>78</sup> An options DPM that is also approved as a STOC DPM/LMM in the underlying security in a side-by-side trading environment is required to disclose on request to all participants in the option or security trading crowd information about aggregate buying and selling interest at different price points represented by limit orders then being represented or otherwise held by the DPM/LMM.<sup>79</sup> Finally, even if the transactions of the STOC DPM/LMM may be in conformity with these proposed rules, a STOC DPM/LMM that engages in transactions for manipulative purposes shall be deemed to be in violation of proposed CBOE Rule 54.7.<sup>80</sup>

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<sup>75</sup> The Exchange defines “side-by-side trading” as the trading of options and their underlying stocks in the same vicinity, though not necessarily by the same DPM, LMM, or firm. See Securities Exchange Act Release No. 47200 (January 15, 2003), 68 FR 3907 (January 27, 2003) (File No. SR-CBOE-2002-63).

<sup>76</sup> The Exchange defines “integrated market making” as the trading of options and their underlying stocks by the same DPM or LMM. See id.

<sup>77</sup> Compare CBOE Rules 54.7 and 54.7A with CBOE Rules 30.18 and 30.18A; see also American Stock Exchange (“Amex”) Rule 175(c).

<sup>78</sup> See CBOE Rule 54.7, Interpretation & Policy .03.

<sup>79</sup> See CBOE Rule 54.7A.

<sup>80</sup> See CBOE Rule 54.7A, Interpretation & Policy .02.

### G. Intermarket Price Protection

A market order or marketable limit order in an ITS-eligible security would not be automatically executed on the STOC System at a price inferior to the best bid or offer on another ITS market.<sup>81</sup> If there were a better quote on another market, the STOC DPM/LMM would be required to handle the order manually, acting as agent for the order.<sup>82</sup> Thus, the STOC DPM/LMM would be required to accord priority to such order over its own orders as principal, unless the person who placed the order had consented to not being accorded such priority.<sup>83</sup> To comply with its obligations under the ITS Plan, CBOE has proposed rules similar to those of another electronic exchange, NYSE Arca (formerly the Archipelago Exchange), that would govern intermarket trading on STOC pursuant to the ITS Plan.<sup>84</sup>

### H. Effective Dates of the Pilot Program

CBOE proposed that the STOC rules operate as a pilot program extending from the date of this approval order to the final compliance date for Rules 610 and 611 of Regulation NMS.<sup>85</sup> CBOE acknowledged that it will need to file additional rule changes to comply with Regulation NMS, and has committed to submitting such filings in a timely manner.<sup>86</sup>

## III. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to

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<sup>81</sup> See CBOE Rules 52.6 and 52.7.

<sup>82</sup> See CBOE Rule 53.56(b)(6).

<sup>83</sup> See id.

<sup>84</sup> See CBOE Rules 55.1 through 55.4.

<sup>85</sup> 17 CFR 242.610 and 242.611.

<sup>86</sup> See Securities Exchange Act Release No. 54332 (August 18, 2006), 71 FR 50480 (August 25, 2006) (SR-CBOE-2006-70).

a national securities exchange.<sup>87</sup> In particular, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,<sup>88</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade; to facilitate 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. The Commission did not receive any comments on the proposal. This Order approves the rule change in its entirety, although only certain aspects of the proposed rules governing the STOC System are discussed below.<sup>89</sup>

A. Priority and Trade Allocation Methodology

The Commission considers the priority and trade allocation methodologies proposed for STOC to be consistent with the Act. These priority and trade allocation rules are similar to the rules approved by the Commission for CBOEdirect.<sup>90</sup>

The Commission notes, in particular, that the STOC rules allow the Exchange to award a STOC DPM/LMM a trade participation right of up to 40% of an incoming order, subject to certain conditions.<sup>91</sup> These guarantees are intended to provide an incentive for assuming the extra responsibilities of a STOC DPM/LMM, such as the obligation to provide opening and continuous quotes in all assigned securities and to act as agent for orders when there is a better

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<sup>87</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>88</sup> 15 U.S.C. 78f(b)(5).

<sup>89</sup> The Commission notes that many of the proposed STOC rules are substantially identical to rules contained in Chapters 30 and 40-46 of CBOE's existing rules, and thus have been previously noticed for comment and approved by the Commission. See, e.g., Securities Exchange Act Release No. 28556 (October 19, 1990), 55 FR 43233 (October 26, 1990) (File No. SR-CBOE-90-08) (approving Chapter 30 of CBOE's rules); CBOEdirect Approval Order (approving Chapters 40-46 of CBOE's rules).

<sup>90</sup> See CBOEdirect Approval Order, 68 FR at 17708-09.

<sup>91</sup> See CBOE Rules 52.1(b)(3) and 53.57.

price on another market. A large guaranteed participation right could erode the incentive of other market makers to make competitive markets. Thus, the Commission must weigh whether a proposed participation right adequately balances the aim of rewarding the specialist with the aim of leaving a sizeable enough portion of the incoming order for the other market makers quoting at the same price. The Commission has previously taken the position that a trade participation right not exceeding 40% is consistent with the Act.<sup>92</sup> Furthermore, the STOC rules require that, if the trade participation right is in effect, the public customer priority must be in effect ahead of the trade participation right.<sup>93</sup> As a result, public customer orders at a certain price would be filled before a STOC DPM/LMM receives its trade participation right at that price. The Commission believes it is not inappropriate for customer orders to have priority over a specialist's trade participation right, and that such priority is consistent with Section 11 of the Act<sup>94</sup> and the rules promulgated thereunder.

The Commission also notes that, if the pro rata priority method is in effect, the public customer priority overlay must also be in effect. As a result, a public customer order will not lose part of a fill to a later arriving professional order at the same price.

#### B. Facilitation and Crossing Orders

CBOE Rule 52.11 permits priority based on size for a facilitation order or the crossing of two agency orders provided the transaction: (1) is for at least 5,000 shares; (2) is for a principal amount of at least \$100,000; and (3) is greater in size than any single public customer order

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<sup>92</sup> See, e.g., Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775, 2789 (January 20, 2004); CBOE direct Approval Order, 68 FR at 17708; Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778, 48787-90 (August 9, 2000); Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11398 (March 2, 2000).

<sup>93</sup> See CBOE Rule 52.1(b)(3)(C).

<sup>94</sup> 15 U.S.C. 78k.

resting on the STOC book at the proposed cross price. The Commission finds that these provisions are consistent with the Act because they strike one reasonable balance between the aim of protecting public limit orders displayed on the book with encouraging broker-dealers to provide significant liquidity by allowing them to arrange crossing orders (whether as agent or principal).<sup>95</sup>

C. Obligations Under the ITS Plan

CBOE is a participant of the Intermarket Trading System and, as such, must comply with the requirements of the ITS Plan with respect to eligible securities. The Commission believes that the STOC rules governing intermarket trading are consistent with the Act. The Commission notes that these rules are closely modeled on those of another electronic exchange, NYSE Arca (formerly the Archipelago Exchange), that previously have been approved by the Commission.<sup>96</sup>

D. Clearly Erroneous Trades

The Commission believes that CBOE Rule 52.4 is consistent with the Act because it is reasonably designed to promote fair and orderly markets by setting forth procedures for reviewing and, if necessary, nullifying or adjusting a clearly erroneous trade. The Commission previously has determined that it is consistent with the Act for an exchange to have discretion to nullify or adjust trades that are clearly erroneous.<sup>97</sup>

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<sup>95</sup> Each member who seeks to execute or participate on either side of a facilitation or crossing trade is responsible for ensuring that its conduct is in compliance with the requirements of Section 11(a) of the Act and the rules promulgated thereunder.

<sup>96</sup> See NYSE Arca Equities (“Arca”) Rules 7.55 through 7.57 (governing ITS transactions on NYSE Arca); Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (File No. SR-PCX-00-25) (approving rules for the Archipelago Exchange).

<sup>97</sup> See Arca Rule 7.10 (Clearly Erroneous Executions); Securities Exchange Act Release No. 28556 (October 19, 1990), 55 FR 43233 (October 26, 1990) (File No. SR-CBOE-90-08) (approving PCX Equities Rule 7.10); NASD Rule 11890 (Clearly Erroneous

E. Side-By-Side Trading and Integrated Market Making

The STOC rules permit side-by-side trading and integrated market making in limited circumstances consistent with those that the Commission has approved for other trading systems, including CBOE's existing equity trading rules.<sup>98</sup> Given the restrictions and disclosure requirement attached to these trading practices, the Commission believes that the STOC rules permitting side-by-side trading and integrated market making are consistent with the Act.

F. Firm Quotations

CBOE Rule 52.13 requires each responsible broker or dealer to be firm for the price and size of its quotation, subject to certain exceptions. The exceptions set forth in CBOE Rule 52.13 for when a quotation may be "non-firm" are consistent with those permitted in the past for CBOEdirect and other electronic systems.<sup>99</sup> In addition, the procedures by which trading officials of the Exchange may determine that unusual market conditions exist, such that they may designate the market in such security to be non-firm, are reasonable and consistent with the Act.

G. Section 11(a) of the Act

Section 11(a) of the Act<sup>100</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person,

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Transactions); Securities Exchange Act Release No. 28556 (October 19, 1990), 55 FR 43233 (October 26, 1990) (File No. SR-CBOE-90-08) (approving NASD Rule 11890).

<sup>98</sup> See CBOE Rules 30.18 and 30.18A; Securities Exchange Act Release No. 47200 (January 15, 2003), 68 FR 3907 (January 27, 2003) (approving same); Amex Rule 175(c); Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002) (approving same).

<sup>99</sup> See, e.g., CBOEdirect Approval Order, 68 FR at 17702; Securities Exchange Act Release No. 49931 (June 28, 2004), 69 FR 40696 (July 6, 2004) (File No. SR-ISE-2004-04) (approving ISE Rule 805(d)); Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775, 2781 (January 20, 2004) (File No. SR-BSE-2002-15) (approving, inter alia, BOX Rules, Ch. VI, Sec. 6(c)(ii)(2)).

<sup>100</sup> 15 U.S.C. 78k(a).

or an account over which it or its associated person exercises discretion (collectively, “covered accounts”) unless an exception applies. Rule 11a2-2(T) under the Act,<sup>101</sup> known as the “effect versus execute” rule, provides exchange members with an exemption from the Section 11(a) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect a transaction for a covered account by arranging for an unaffiliated member to execute the transaction on the exchange. To comply with Rule 11a2-2(T)’s conditions, a member (1) must transmit the order from off the exchange floor; (2) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution; (3) may not be affiliated with the executing member; and (4) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in the connection with effecting the transaction, except as provided in the rule.

In letters to the Commission,<sup>102</sup> the Exchange represented that transactions effected on the STOC System meet the requirements of Rule 11a2-2(T). Based on these representations, the Commission believes that the STOC System satisfies the four conditions of Rule 11a2-2(T).

First, the rule requires that orders be transmitted from off the Exchange floor. The Commission has considered the off-floor transmission requirement in the context of several automated trading and electronic order-handling facilities operated by various national securities exchanges, and has determined that a covered account order sent through such an exchange facility would be deemed to be transmitted from off the floor.<sup>103</sup>

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<sup>101</sup> 17 CFR 240.11a2-2(T).

<sup>102</sup> See Letters from Angelo Evangelou, Assistant General Counsel, CBOE, to Kelly M. Riley, Assistant Director, Division of Market Regulation (“Division”), Commission, dated August 22, 2006, and September 7, 2006.

<sup>103</sup> Among the systems considered by the Commission were (1) CBOEdirect (see Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Angelo Evangelou, Senior Attorney, CBOE, dated March 31, 2003 (“CBOEdirect Letter”)); (2) the Amex



CBOE, however, stated in its letter that its floor members would be permitted to send orders to the STOC System from CBOE's options trading floor. The Commission has stated that the off-floor transmission requirement may be met when an order is sent from one trading floor of an exchange to another, separate trading floor of the same exchange.<sup>104</sup> CBOE represented that securities traded on CBOE's options trading floor will not be traded on the STOC platform. On the basis of the Exchange's representations, the Commission believes that orders sent by electronic means from the Exchange's trading floor may be considered to be sent from "off-floor" for purposes of the STOC System. Specifically, the Commission believes that, because the securities traded on STOC are not traded on CBOE's physical trading floor, the STOC System is essentially a different, separate trading floor.

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Automatic Execution System (see Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Jeffrey P. Burns, Assistant General Counsel, Amex, dated July 9, 2002); (3) the Pacific Exchange's ("PCX") Archipelago Exchange Facility (see Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Kathryn L. Beck, Senior Vice President, PCX, dated October 25, 2001); (4) the Philadelphia Stock Exchange's ("Phlx") VWAP Trading System (see Letter from Larry E. Bergmann, Senior Associate Director, Division, Commission, to Edith Hallahan, Associate General Counsel, Phlx, dated March 24, 1999 ("VWAP Letter")); (5) the PCX Application of the OptiMark System (see Letter from Catherine McGuire, Chief Counsel, Division, Commission, to David E. Rosedahl, PCX, dated November 30, 1998 ("Optimark Letter")); (6) Chicago Match (see Letter regarding Chicago Match, from Brandon Becker, Director, Division, Commission, to George T. Simon, Foley & Lardner, dated November 30, 1994 ("Chicago Match Letter")); (7) the ITS (see Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979), nn. 20-27 and accompanying text ("1979 Release")); (8) Amex's Post Execution Reporting System and the Amex Switching System (see *id.* at n. 25); (9) the PCX's Communications and Execution System ("COMEX") (see *id.* at n. 25); (10) Phlx's Automated Communications and Execution System ("PACE") (see *id.* at n. 25); and (11) the Cincinnati Stock Exchange's Multiple Dealer Trading Facility (see *id.* at nn. 28-35 and accompanying text).

<sup>104</sup> See Securities Exchange Act Release No. 52094 (July 21, 2005), 70 FR 43913, 43916 (July 29, 2005) (regarding CHX's electronic book); see also letter from Richard A. Steinwurtzel, Attorney, Office of Chief Counsel, Division, Commission, to Philip J. Lo Bue, Senior Vice President, PCX, dated December 22, 1978.

The Commission notes that CBOE floor members will not have a time/place advantage with regard to securities traded on STOC. CBOE stated that the servers for the STOC System are physically separate from the options trading floor. Thus, according to CBOE, orders transmitted from the Exchange's options trading floor would not be processed any more quickly than orders received from another location. In addition, CBOE represented that all orders—whether submitted from the Exchange's options trading floor or from another location—would be routed through the same electronic “front door” at the Exchange and into a single stream of orders that would be handled by the STOC System. Finally, floor members will see information about orders that are at the top of the electronic book at the same time as the public. Specifically, information about orders at the top of the STOC Book would be displayed to the CBOE trading floor after such information has been sent to the securities information processor that disseminates it to the public. Based on these facts, the Commission believes the off-floor transmission requirement is satisfied in this case.

Second, the rule requires that the member not participate in the execution of its order. In its letter of August 22, 2006,<sup>105</sup> the Exchange represented that its members will relinquish control of orders after they are submitted to the STOC System and noted that the members will not receive special or unique trading advantages.<sup>106</sup> Third, although Rule 11a2-2(T) contemplates having an order executed by an exchange member who is unaffiliated with the member initiating the order, the Commission has recognized that the requirement is satisfied

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<sup>105</sup> See supra note 102.

<sup>106</sup> See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225, 55232 (November 1, 2001) (approving the PCX's Archipelago Exchange Facility); 1979 Release at 6086 n. 25. See also CBOEdirect Letter, VWAP Letter, Optimark Letter, Chicago Match Letter.

when automated exchange facilities are used.<sup>107</sup> Finally, in its letter the Exchange represents that members that rely on Rule 11a2-2(T) for a managed account transaction must comply with the limitations on compensation set forth in the rule.

#### H. Pilot Program

The Commission is approving the STOC rules on a pilot basis. Although CBOE represents that the STOC System will require additional rule changes to comply with Regulation NMS, the Commission believes it is appropriate for CBOE to implement the new rules described above to enhance its abilities to trade non-option securities in the interim. Nothing in this Order should be construed as altering any obligation imposed on CBOE by Rules 610 and 611 of Regulation NMS.<sup>108</sup>

#### I. Accelerated Approval of Amendment No. 2

Pursuant to Section 19(b)(2) of the Act,<sup>109</sup> the Commission finds good cause for approving the amended proposal prior to the thirtieth day after the publication of Amendment No. 2 in the Federal Register. Amendment No. 2 revised the proposal to require that the public customer priority overlay be activated whenever pro rata priority is in use, to delete provisions relating to complex orders, and to amend the requirements for executing a facilitation or crossing transaction with priority over existing interest on the book. These changes further public customer protection by reducing the likelihood that a public customer order will lose all or part

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<sup>107</sup> In considering the operation of automated execution systems operated by an exchange, the Commission has noted that, while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release at 6086 n. 25.

<sup>108</sup> 17 CFR 242.610 and 242.611.

<sup>109</sup> 15 U.S.C. 78s(b)(2).

of a fill to a later arriving professional order at the same price. Amendment No. 2 also made clarifications to the proposed rule change that do not alter the substance of the proposed rules and thus are appropriate for accelerated approval. Accordingly, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,<sup>110</sup> to approve the proposed rule change, as amended, prior to the thirtieth day after publication of the notice of filing of Amendment No. 2 thereto in the Federal Register.

#### IV. Solicitation of Comments Concerning Amendment No. 2

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether it is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-21 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2004-21. 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

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<sup>110</sup> 15 USC 78s(b)(2).

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-2004-21 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>111</sup> that the proposed rule change (File No. SR-CBOE-2004-21), as amended, is approved, and that Amendment No. 2 thereto is approved on an accelerated basis, as a pilot program, until the final compliance date for Rules 610 and 611 of Regulation NMS.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>112</sup>

Nancy M. Morris  
Secretary

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<sup>111</sup> Id.

<sup>112</sup> 17 CFR 200.30-3(a)(12).