

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-55034; File No. SR-CBOE-2006-112)

December 29, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change Relating to Its Non-option Security Trading Rules

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> notice is hereby given that on December 29, 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, II, and III below, which Items have been substantially prepared by the Exchange. 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 submits this rule change filing to modify its non-option security trading rules. The text of the proposed rule change is available at CBOE, the Commission’s Public Reference Room, and [www.cboe.com](http://www.cboe.com).

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 Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

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

1. Purpose

In September 2006, the Commission approved Exchange Chapters 50-55 governing the trading of non-option securities on the Exchange.<sup>3</sup> Also in September 2006, the Commission approved modifications<sup>4</sup> to the Exchange's non-option trading rules to conform those rules to aspects of Regulation NMS.<sup>5</sup> Thus, the Exchange currently operates a purely electronic stock trading platform that has in place certain rules required by Regulation NMS in order to qualify as a market center with protected quotations. The Exchange now proposes to further modify Chapters 50-55 in connection with the establishment of the CBOE Stock Exchange ("CBSX"). CBSX would be a facility of the Exchange and serve as the Exchange's vehicle for trading non-option securities. CBSX would be a separate legal entity (a Delaware Limited Liability Company) owned by the Exchange and several strategic partners (the Exchange owns roughly half of CBSX). The Exchange has submitted a separate rule filing proposing to establish CBSX as a facility of the Exchange.<sup>6</sup> This filing changes certain portions of the Exchange's non-option trading rules to fit the market model envisioned for CBSX. These changes are described below.

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

<sup>3</sup> See Securities Exchange Act Release No. 54422 (September 11, 2006), 71 FR 54537 (September 15, 2006) (approving SR-CBOE-2004-21).

<sup>4</sup> See Securities Exchange Act Release No. 54526 (September 27, 2006), 71 FR 58646 (October 4, 2006) (approving SR-CBOE-2006-70).

<sup>5</sup> 17 CFR 242.600 et seq.

<sup>6</sup> See SR-CBOE-2006-110 (filed December 26, 2006).

a. Agency Function

Under the current rules, DPMs on the system serve as agent for certain orders that must be processed “manually.” More specifically, in the event the Exchange is not the NBBO at the time a marketable order is received and no market-makers on the Exchange step up to match the NBBO price, the order is routed to the DPM for manual handling. As part of this manual handling, the DPM determines whether to provide price improvement for the order or whether to route it to the NBBO market for execution. During this time, and during any time that the order is routed, the DPM acts as agent for the order. The other instance in which DPMs perform an agency function is in the execution of pre-opening orders at the opening price of the primary market for stocks in which the Exchange is not the primary market. The Exchange now proposes to eliminate all agency functions for CBSX DPMs.

The Exchange intends for the CBSX system (it’s the same system as the current system—just a new name) to automatically route marketable non-IOC orders to other market centers when CBSX is not the NBBO and no market-makers have stepped up to match the NBBO. This routing logic is contained in the CBSX trade engine, and CBSX would use an unaffiliated routing broker pursuant to an agreement to transmit orders on CBSX’s behalf to better-priced protected quotations consistent with Regulation NMS. The handling and routing would all be done electronically by the CBSX system without any manual intervention. As far as the opening, the Exchange proposes to eliminate a DPM’s agency obligation to manually execute orders in connection with the opening print on the primary market by changing the time in which CBSX will open. CBSX would enter an open state at 8:15 a.m. Chicago time (before the primary market openings). The opening would be automatically performed by the system. That is, the CBSX system would automatically execute pre-opening orders at a price that allows

the greatest number of pre-opening shares to trade. This would allow customers that are interested in an opening execution on CBSX to obtain one without CBSX needing to obligate DPMs to guarantee the opening price on the primary market.

b.      **CBSX Floor Post**

The current stock trading system is purely electronic. CBSX also would be purely electronic in that all trades on CBSX must be effected electronically; however, CBSX would utilize a space on the Exchange's trading floor for price discovery purposes (the "CBSX Floor Post"). CBSX DPMs will be required to staff the CBSX Floor Post and respond to price discovery inquiries from brokers. All orders entered at the CBSX Floor Post would be handled and executed in the exact same manner as orders entered from any other location. The CBSX Floor Post would be located near the Exchange's index options pits in a location that is generally isolated from the equity options trading posts. The Exchange is hopeful that the CBSX Floor Post would be a valuable resource for CBOE floor brokers to inquire about depth of liquidity on CBSX (e.g., CBOE brokers often represent complex orders that contain a stock component and could seek to execute the stock component on CBSX).

c.      **Order Types**

The Exchange also proposes to adopt several new order types in connection with the CBSX launch. Specifically, CBSX would offer Reserve Orders, Middle Market Cross Orders, Cross Only Orders, and Cross and Sweep Orders.

A Reserve Order is a limit order in which the order originator designates a portion of the order for display and dissemination (the "display amount") and designates a portion of the order in "reserve." A reserve portion is not displayed but is available for execution against incoming orders. Reserve Orders would be last in priority (except that most contingency orders are behind

Reserve Orders in priority). Between Reserve Orders at the same price, priority would be afforded utilizing the matching algorithm in effect for the stock. If, after an execution against a Reserve Order, a quantity remains on the Reserve Order, the quote would be refreshed to disseminate the display amount while any remaining balance would be retained in reserve.

A Middle Market Cross Order is an order submitted to trade at the midpoint of the NBBO. It must always be submitted with a contra order for the same size and could be entered only when the bid price for the stock is \$1 or greater. Further, these orders could be executed in increments as small as  $\frac{1}{2}$  the minimum quoting increment established under CBSX rules. If a Middle Market Cross Order is submitted after CBSX is open but before other markets are open (e.g., 8:20 a.m. Chicago time) the order would execute at the midpoint of the best bid and offer among market centers that are open and disseminating quotes (or just the CBSX midpoint if CBSX were the only market center open). A member would be prohibited from entering a Middle Market Cross Order as principal buyer (seller) if the NBBO spread is one cent wide and that member was an agent for any customer order resting at the prevailing NBBO bid (offer). This provision is meant to preclude a member from trading as principal at a price that is less than one cent better than a price expressed by a customer of that member to which the member has a fiduciary obligation.

A Cross Only Order is an order that may only be executed against another Cross Only Order for the same size and price. These orders could be entered only at or between the NBBO, and when entered at the CBSX BBO, only when the terms of the orders meet the crossing parameters set forth in proposed CBSX Rule 52.11 relating to priority for crosses at the CBSX's disseminated market price.

A Cross and Sweep Order is an order that is priced outside of the NBBO and/or the BBO where the applicable side of the CBSX Book is satisfied by the Cross and Sweep Order and any disseminated better priced protected quotations at away market centers are swept with ISOs by the CBSX System. Any remaining balance on a partially executed Cross and Sweep Order would be cancelled by the CBSX System.

CBOE also proposes to modify the manner in which Stop Orders (including Stop Limit Orders) are handled. Current rules provide that a stop buy (sell) order is elected when the stock trades or is bid (offered) at or above (below) the stop price. As proposed, CBSX would handle stop orders so that a stop buy (sell) order is elected only when the stock trades at or above (below) the stop price on the primary market for the stock. The change is consistent with the desires of CBSX customers.

d. Order Routing

Rule 52.6 (Processing of Round-Lot Orders) is being modified to add additional descriptive language regarding transmission of ISOs to other market centers on behalf of marketable orders received by CBSX. This language complements language already in place regarding ISO routing in Rule 52.7.

e. Odd Lots

CBSX would process odd lots differently than provided for under current rules. More specifically, CBSX proposes to execute odd lots at the best price being quoted by CBSX Market-Makers at the time of receipt. A limit odd-lot order would execute only once it became marketable against a CBSX Market-Maker quote/order. Further, the odd-lot portion of a mixed lot would execute as described above while the round-lot portion of the mixed lot would execute as if it were received by the system as a round lot.

f. Market-Makers

CBSX Market-Makers will function in a manner similar to what is provided by the current rules with a few changes. First, because CBSX would have a location on the Exchange trading floor for price discovery, CBSX DPMs (LMMs) would be required to maintain staffing at that post in order to handle price discovery inquiries. CBSX Remote Market-Makers, however, would be expected to operate in a remote capacity (thus the name Remote Market-Maker).

Second, CBSX anticipates adopting a fee structure that would contemplate discounted fees for CBSX Market-Makers that meet certain competitive quoting thresholds. These parameters would be set forth in a separate rule filing. In connection with these parameters, CBOE proposes to adopt a provision in Rule 53.55 stating that routine failure to qualify for the thresholds set forth in the fee incentive program could subject a CBSX DPM to remedial action by CBSX under that rule.

Lastly, CBOE has submitted as separate rule filings changes to Rules 53.53 and 53.54 to allow CBSX to allocate securities to anticipated CBSX DPMs in advance of the launch of the CBSX platform.<sup>7</sup>

g. Section 11(a)

Section 11(a) of the Act<sup>8</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for his own account, the account of an associated person,

<sup>7</sup> See Securities Exchange Act Releases No. 54792 (November 20, 2006), 71 FR 68659 (November 27, 2006), and 54831 (November 29, 2006), 71 FR 70814 (December 6, 2006).

<sup>8</sup> 15 U.S.C. 78k(a).

or an account over which he or his associated persons exercise investment discretion (collectively, the “covered accounts”) unless an exception applies. Congress intended Section 11(a) to address concerns about special time and place advantages that floor-based members of an exchange might have over persons who were not on the floor—such as the ability to “execute decisions faster than public investors.”<sup>9</sup> Rule 11a2-2(T) under the Act<sup>10</sup> provides exchange members with an exception to the trading prohibition.<sup>11</sup>

The Exchange believes that most orders entered into CBSX would qualify for Rule 11a2-2(T) for the same reasons that orders submitted to all-electronic exchanges typically qualify for Rule 11a2-2(T)—namely, because as an electronic marketplace where all orders must be entered into the system for execution and handling, there really is no “floor.” However, to the extent members seeking to electronically enter orders while positioned at the CBSX Floor Post might not qualify under Rule 11a2-2(T), the Exchange believes that such members will, by default, qualify for the exemption contained in paragraph (g) of Section 11(a), which exemption

<sup>9</sup> See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (“1978 Release I”); Securities Exchange Act Release No. 14713 (April 27, 1978), 43 FR 18557, 18588 (May 1, 1978) (“1978 Release II”); Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084, 6092 (January 31, 1979) (“1979 Release”). The 1978 and 1979 Releases cite the House Report at 54-57.

<sup>10</sup> 17 CFR 240.11a2-2(T).

<sup>11</sup> Known as the “effect versus execute” rule, 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 floor. To comply with the rule’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 his associated person may retain any compensation in connection with effecting the transaction without express written

essentially provides that members must yield priority to all non-members. Orders entered at the CBSX Floor Post based on price discovery discussions with the CBSX DPM would certainly be entered as cross orders. The Exchange believes that all of the CBSX cross-order types would be consistent with the notion of yielding to existing interest at the crossing price. As described above, Middle Market Cross Orders are priced where there is no existing interest and therefore no interest to yield to. Cross Only orders would cancel if any interest in the system could trade with any part of the cross transaction, and Cross and Sweep Orders would satisfy all interest at the cross price prior to effecting the cross trade.

The Exchange notes that a feature contained in proposed Rule 52.11 that would allow a qualifying cross transaction to establish priority over existing bids/offers on the CBSX Book would not be enabled until functionality is developed that would allow the member a choice as to whether to apply the priority feature of Rule 52.11 in connection with any of the CBSX cross-order types.<sup>12</sup> Once that choice is in place, a member seeking to qualify under paragraph (g) of Rule 11a2-2(T) could effect a cross without the priority feature of Rule 52.11 and a member that is exempt from Section 11(a) for reasons other than paragraph (g) could effect a cross with the priority feature of Rule 52.11.

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consent from the person authorized to transact business for the account in accordance with the rule.

<sup>12</sup> Rule 52.11 provides that a CBSX Trader that wishes to cross two original orders or to facilitate an original order at the established bid or offer irrespective of existing interest at such bid/offer may do so provided the cross 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 CBSX Book at the proposed cross price.

h. ITS

All rules regarding the Intermarket Trading System are being deleted as the Exchange anticipates using private linkages under the CBSX platform and because the ITS Plan will terminate at the commencement of the compliance date for Regulation NMS in February 2007.

i. Elimination of Unnecessary Rules

Certain existing rules are being eliminated because the Exchange does not believe that they are necessary or relevant to the operation and regulation of the CBSX platform. Paragraph (a) of Rule 52.5 is being eliminated because it merely describes order maintenance functionality available to users and that sort of descriptive language is not normally contained in exchange rules. Paragraph (b) of Rule 52.5 is being eliminated because the Exchange does not want to prohibit market participants from resting buy and sell orders simultaneously in the same security. Rule 53.3(a)(2) is being eliminated because the Exchange does not believe it is necessary to limit a member's ability to fill a customer order only pursuant to the CBSX crossing rule (Rule 52.11). Rule 53.7 is being eliminated because the Exchange does not contemplate trading SuperShares at this time. Rule 53.52 is being eliminated because CBSX would not utilize (and does not need) the concept of individual DPM Designees (DPM firms are the recognized traders). Finally, Rule 53.70 is being eliminated because CBSX would not utilize (and does not need) the concept of Clearing Firm Brokers.

j. Inserting “CBSX”

The proposed rule change replaces all references to the “STOC” system or platform with “CBSX” and also replaces references to various Exchange committees with “CBSX.”

k. Conclusion

In conclusion, the Exchange believes that CBSX would provide a fast and competitive stock trading platform that would be attractive to customers. The Exchange anticipates launching CBSX concurrent with the start of the compliance date for Regulation NMS. Accordingly, the Exchange requests that the proposed rule change not take effect or become operative until February 5, 2007. The Exchange notes that existing Chapters 50-55 are approved as a pilot which terminates in connection with the compliance dates for Regulation NMS. The Exchange hopes approval of these rule changes would allow a seamless migration to CBSX at that time.

2. Statutory Basis

CBOE believes the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>13</sup> Specifically, the Exchange believes the proposed rule change is consistent with the requirements of Section 6(b)(5)<sup>14</sup> 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 believes that this proposed rule change would not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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<sup>13</sup> 15 U.S.C. 78f(b).

<sup>14</sup> 15 U.S.C. 78f(b)(5).

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.

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 Exchange consents, the Commission will:

- (A) by order approve the 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 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-2006-112 on the subject line.

##### **Paper Comments:**

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

All submissions should refer to File Number SR-CBOE-2006-112. 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 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-2006-112 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.<sup>15</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>15</sup> 17 CFR 200.30-3(a)(12).