SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55392; File No. SR-CBOE-2006-112)

March 2, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval to a Proposed Rule Change as Modified by Amendment No. 1 Relating to Its Non-option Security Trading Rules

I. Introduction

On December 29, 2006, 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" or "Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposal to modify its trading rules for non-option securities. The proposal was published for comment in the Federal Register on January 11, 2007.[3] The Commission received no comments on the proposal. The Exchange filed Amendment No. 1 with the Commission on March 2, 2007.[4] This order provides notice of and solicits comment on the proposed rule change as modified by Amendment No. 1 and approves the proposal on an accelerated basis.

II. Description of the Proposal

In September 2006, the Commission approved Exchange Chapters 50-55 governing the trading of non-option securities on the Exchange through a new electronic trading platform

---

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 55034 (December 29, 2006), 72 FR 1350 (the "Notice").

4 Amendment No. 1 amended the proposal: (i) to set forth restrictions on the use of hand signals between the CBSX Floor Post and the option trading posts; (ii) to limit the types of proprietary orders that may be submitted by non-DPM members at the CBSX Floor Post; and (iii) to allow CBSX traders to avail themselves of any exemptions from Rule 611 of Regulation NMS that are granted by the Commission.

known as Stock Trading on CBOEdirect ("STOC").[5] Also in September 2006, the Commission approved modifications[6] to the STOC rules to conform them to aspects of Regulation NMS.[7] In this filing, the Exchange proposes to further modify its trading rules for equity securities and rename its equity trading facility the CBOE Stock Exchange ("CBSX").[8] CBOE anticipates launching CBSX as of the compliance date for Regulation NMS. A full discussion of the proposed rule change is set forth in the Notice; significant aspects of the proposal are discussed below.

First, the Exchange has proposed to further automate order handling and trade-through prevention. Under the current rules, if CBOE receives an order in an equity security when it is not at the national best bid or offer ("NBBO"), the designated primary market-maker ("DPM") for that security must route the order to the NBBO market for execution if no STOC trader steps up to match the NBBO. The Exchange now proposes to program CBSX to automatically route, via an unaffiliated routing broker, a marketable order in such circumstances (except if the order is labeled immediate-or-cancel ("IOC")).[9]

---

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

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

7 17 CFR 242.600 et seq.

8 The Exchange separately filed with the Commission a proposal to establish a new corporate structure for CBSX (the "CBSX Facility Filing"). See Securities Exchange Act Release No. 55172 (January 25, 2007), 72 FR 4745 (February 1, 2007) (notice of filing of SR-CBOE-2006-110). The Commission also approves the CBSX Facility Filing today. See Securities Exchange Act Release No. 55389 (March 2, 2007).

9 IOC orders would be cancelled if a better-priced protected quotation existed on another exchange. See CBOE Rule 51.8(g)(4). In addition, the Commission notes that an Intermarket Sweep Order ("ISO") received by CBSX will be executed or cancelled immediately and not "flashed" to CBSX traders for possible matching of the NBBO. See CBOE Rule 51.8(n).

Second, the Exchange has proposed to move the CBSX opening from 8:30 a.m. Central Time ("CT") to 8:15 a.m. CT and eliminate a DPM's obligation to open its assigned securities at a single price that matches the primary market or at a price that does not trade-through another exchange's quote. At the opening, the CBSX system would automatically execute pre-opening orders at a price that allows the greatest number of shares to trade.

Third, the Exchange is proposing to add a floor component to its electronic trading system. CBSX would dedicate a space on the Exchange's trading floor (the "CBSX Floor Post") that CBSX DPMs will be required to staff for the purpose of responding to price discovery inquiries from brokers. Open-outcry trading is not permitted, and time priority would attach to the order only when it was entered into the system. Any order entered at the CBSX Floor Post would be executed electronically in the same manner as an order entered from any other location. In Amendment No. 1, the Exchange also proposed to amend the rule governing the CBSX Floor Post to permit only cross orders and IOC orders to be submitted by non-DPM members from the CBSX Floor Post.

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. Proposed Rule 51.12 stipulates that there shall be no direct sightlines between the CBSX Floor Post and the equity option trading posts. In Amendment No. 1, the Exchange is adding restrictions on the use of hand signals between the CBSX Floor Post and the equity option trading posts.

Fourth, the Exchange proposes to adopt the following new order types in connection with the establishment of CBSX:

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. If a quantity remains on the Reserve Order after an execution, the order would be refreshed to include the display amount while any remaining balance would remain 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. These orders could be executed in increments as small as one-half the minimum quoting increment established under CBSX rules. However, proposed CBSX Rule 51.8(p) would prohibit a member from entering a Middle Market Cross Order as principal buyer (seller) if the NBBO spread is one cent wide and that member is an agent for any customer order resting at the prevailing national best bid (offer).

A Cross Only Order is an order that could be executed only 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. In other words, before executing the cross, a Cross and Sweep Order will satisfy (i) any protected quotations that are priced better than the crossing price, and (ii) any interest on CBSX that is priced at or better than the crossing price. Any remaining imbalance on either side of a partially executed Cross and Sweep Order which results from satisfying protected quotations or other CBSX interest would be cancelled by the CBSX system.

The Exchange proposes to modify the manner in which Stop Orders (including Stop Limit Orders) are handled. CBOE rules currently provide that a stop buy (or sell) order is elected when the stock trades, or is bid (or offered), at or above (or below) the stop price on the Exchange. The Exchange proposes to change the provision that stipulates when a stop buy (or sell) order is elected to state that the order is elected only when the stock trades (not when the stock is bid or offered) at, or above or below, the stop price. The Exchange also proposes to change the rule to provide that a stop buy (or sell) order is elected when the stop price is reached on the primary market for the stock, rather than on CBSX.

Fifth, in Amendment No. 1, the Exchange has proposed to amend CBOE Rule 52.7, "Sweeping and Trading Through Away Markets," to incorporate any future exemptions from Rule 611 of Regulation NMS (the "Order Protection Rule")[10] granted by the Commission. Rule 52.7 already incorporates several of the exceptions codified in Rule 611(b) of Regulation NMS. With this provision, CBSX would automatically incorporate into its rules any future exemptions from the Order Protection Rule granted by Commission order.

Sixth, CBOE proposes to adopt a provision in Rule 53.55 stating that routine failure to qualify for the thresholds set forth in any fee incentive program[11] that may be employed by CBSX from time to time could subject a DPM to remedial action by CBSX under that rule.

Seventh, 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.[12] Most notably, all rules regarding the Intermarket Trading System are being deleted as the Exchange anticipates using private linkages with the CBSX platform and because the ITS Plan will terminate upon the trading phase date for Regulation NMS.

---

[10] 17 CFR 242.611.

[11] CBSX has also adopted, via a separate rule filing, a fee structure that would discount fees for CBSX Market-Makers that meet certain competitive quoting thresholds. See File No. SR-CBOE-2007-25 (filed March 1, 2007).

[12] See Notice, 72 FR at 1352 (discussing these proposed changes).

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 a national securities exchange.[13] In particular, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,[14] 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 proposed rule change, as modified by Amendment No. 1, in its entirety, although only selected aspects of the proposed rules governing the CBSX system are discussed below.

A. Compliance with the Order Protection Rule

The Order Protection Rule of Regulation NMS provides that a trading center shall establish policies that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks that do not fall within one of the enumerated exceptions of the Rule. The Commission believes that the proposed CBSX rules are reasonably designed to promote compliance with the Order Protection Rule. The CBSX system is programmed to automatically process and route orders to avoid trading through any protected quotations on away markets. Like its predecessor, the STOC system, CBSX will automatically match a market or marketable limit order against the best-priced orders in the CBSX book until the order is fully

---

13 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).

14 15 U.S.C. 78f(b)(5).

executed or until an execution would result in a trade-through of a protected quotation at another automated market center (unless an exception is available). An incoming order (other than an IOC order or ISO) in a security will be "flashed" to CBSX traders for a short period if CBSX is not at the NBBO for that security. If no CBSX trader determines to step up and match the NBBO, the order will be routed to the market center disseminating the protected quotation for execution. Under the existing rules, such orders would be routed manually by the DPM. CBOE now proposes that CBSX would route such orders automatically, via an unaffiliated routing broker. As a result, CBSX DPMs would no longer serve as agent for such orders.

B. <u>CBSX Opening Procedures</u>

Proposed Rule 51.2(a) provides that the CBSX system would open for trading at 8:15 a.m. CT (9:30 a.m. Eastern Time), 15 minutes before the primary markets. The Commission believes that establishing trading hours is generally within the business discretion of an exchange, and CBOE's proposal in this regard does not appear to raise any regulatory issues. The Commission notes that other exchanges have trading sessions before 9:30 a.m. Eastern Time.

Proposed Rule 52.2 provides that the CBSX system would automatically open each security at a price that provides the highest matched quantity of order volume. In connection with the automation of the opening, the Exchange also proposes to eliminate a DPM's obligation to open a security at a single price that matches the opening price on the primary market. The Commission believes that the proposed opening matching algorithm is reasonable and consistent with the Act.

C. <u>Hybrid Trading Model</u>

The Commission believes that CBOE's integration of the electronic CBSX system with a post on the Exchange floor is generally consistent with the Act and is within the business discretion of the Exchange. The Commission previously has found hybrid trading rules of other exchanges to be consistent with the Act.[15]

The CBSX Floor Post is near the posts where related options may be traded. CBOE has proposed to prohibit members from using hand signals or other like means of communication to communicate between the CBSX Floor Post and the equity options trading posts. CBOE's proposed rule is substantially similar to policies adopted by the American Stock Exchange in connection with its proposal to permit side-by-side trading that the Commission previously has found consistent with the Act.[16] For the same reasons, the Commission believes that the CBOE rule also is consistent with the Act

CBOE also has proposed to prohibit members, except DPMs, from entering proprietary orders while at the CBSX Floor Post, unless such orders are cross orders or IOC orders. These restrictions appear reasonably designed to prevent a non-DPM CBOE member from executing a trade ahead of a non-member at the same price and thus are generally consistent with Section 11(a) of the Act.[17]

D. New Order Types

The Exchange proposes to adopt several new order types in connection with the establishment of CBSX: Reserve Orders, Middle Market Cross Orders, Cross Only Orders, and Cross and Sweep Orders. The Commission finds that the rules relating to these order types are consistent with the Act and should provide market participants with additional flexibility in

---

15 See Securities Exchange Act Releases No. 54552 (September 29, 2006), 71 FR 59546 (October 10, 2006) (approving the Amex Auction & Electronic Market Integration hybrid market structure) and 53539 (March 22, 2006), 71 FR 16353 (March 31, 2006) (approving the NYSE Hybrid Market).

16 See Securities Exchange Act Release No. 39631 (February 9, 1998), 63 FR 8229 (February 18, 1998) (approving SR-Amex-97-37).

17 15 U.S.C. 78k(a).

executing transactions while protecting displayed interest on the CBSX book and protected quotations of other trading centers.

The Commission notes in particular that it previously has approved order types on other exchanges similar to what CBOE terms the Middle Market Cross Order.[18] The Commission notes that proposed CBSX Rule 51.8(p) prohibits a member 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 would preclude a member from trading as principal at a price that is less than one cent better than a price expressed by its customer. By requiring at least a one-cent improvement over the customer limit order that the member represents as agent, this rule promotes compliance by the member with its Manning obligation to the customer order.[19]

E. Accelerated Approval

Pursuant to Section 19(b)(2) of the Act,[20] the Commission finds good cause for approving the proposal prior to the thirtieth day after the publication of the proposal, as modified by Amendment No. 1, in the Federal Register. The revisions to the proposed rule change made by Amendment No. 1 do not raise any novel or substantive regulatory issues. Therefore, the Commission finds good cause for approving the amended proposal on an accelerated basis.

---

18 See, e.g., Securities Exchange Act Releases No. 54528 (September 28, 2006), 71 FR 58650 (October 4, 2006) (approving SR-ISE-2006-48) and 54101 (July 5, 2006), 71 FR 39382 (July 12, 2006) (approving SR-NASD-2005-140).

19 See NASD Interpretive Materials 2110-2.

20 15 U.S.C. 78s(b)(2).

IV. Solicitation of Comments Concerning Amendment No. 1

Interested persons are invited to submit written data, views, and arguments concerning the proposed rule change as modified by Amendment No. 1, 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. 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, Station Place, 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 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-2006-112 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,[21] that the proposed rule change (File No. SR-CBOE-2006-112), as modified by Amendment No. 1, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[22]

Florence E. Harmon
Deputy Secretary

---

21 Id.

22 17 CFR 200.30-3(a)(12).