

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-55724; File No. SR-CBOE-2007-39)

May 8, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change Regarding Penny Price Improvement

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 April 24, 2007, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the CBOE. 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 CBOE proposes to amend its Rules regarding penny price improvement for options not currently quoted in one-cent increments. The text of the proposed rule change is set forth below. Proposed new language is underlined; and proposed deletions are [bracketed].

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Rule 6.13B. Penny Price Improvement

The Exchange may designate one or more options trading on the Hybrid System for inclusion in the Penny Price Improvement Program. Under this program, the Exchange will allow all users to provide price improvement beyond the Exchange's disseminated quotation (“Penny Pricing”) for classes or series that are not already quoted in one-cent increments and for which the Simple Auction Liaison system in Rule 6.13A is not in effect.

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

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

(a) Electronic Penny Pricing. Electronic penny prices may be established as follows:

(1) Market-Makers. Market-Makers may electronically provide the Exchange with indications of interest that are superior to their own quotations in increments no smaller than one-cent. Such indications shall be firm for all interest received by the Exchange. The Exchange shall disseminate such interest using standard quoting increments by rounding the limit price to the nearest standard quoting increment that does not violate the limit price.

(2) Orders. Public Customers and all other users may electronically submit to the Exchange orders priced in one-cent increments. The Exchange shall disseminate such orders using standard quoting increments by rounding the limit price to the nearest standard quoting increment that does not violate the limit price.

All Penny Pricing submitted pursuant to (1) or (2) above shall be filed by the System for order allocation purposes but shall not be visible. The Exchange may append an indicator to its disseminated quotation to indicate the existence of Penny Pricing in the relevant side of a series when it exists, but no information regarding the price and size of the Penny Pricing shall be made available.

If an order is received by the Hybrid System that could trade against Penny Pricing and where the Exchange's disseminated quotation is the NBBO, it will automatically execute against the Penny Pricing pursuant to the Exchange's normal allocation procedures.

(b) Open Outcry Penny Pricing. Oral bids (offers) provided by in-crowd market participants may be expressed in one-cent increments in response to an order represented in open outcry provided that: (1) the oral bids (offers) better the corresponding bid (offer) in the Exchange's

disseminated quotation; and (2) any resulting transaction(s) is consistent with the requirements of Rule 6.83.

The appropriate Procedure Committee may also determine on a class-by-class basis to make the split-price priority provisions of Rule 6.47 applicable to a class that is subject to Penny Pricing under this rule.

For purposes of this rule, “in-crowd market participants” includes in-crowd Market-Makers, an in-crowd DPM or LMM, and Floor Brokers or PAR Officials representing orders in the trading crowd.

(c) Prior to effecting any transactions in open outcry in one-cent increments, Exchange members must electronically “sweep” any Penny Pricing interest in the Hybrid System so as not to violate the priority of such Penny Pricing.

(d) All pronouncements regarding the applicability of this rule will be announced to the membership via Regulator Circular.

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Rule 6.45 Priority of Bids and Offers - Allocation of Trades

Except as provided by Rules, including but not limited to Rule 6.2A, 6.8, 6.9, 6.13, 6.13B, 6.45A, [Rule] 6.47, [Rule] 6.74, [Rule] 8.87 and [CBOE] Exchange Regulatory Circulars approved by the [SEC] Commission concerning Participation Entitlements [Rights], the following rules of priority shall be observed with respect to bids and offers:

(a)-(e) No change.

... Interpretations and Policies:

.01-.02 No change.

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

6.45A Generally: No change.

(a)-(e) No change.

... Interpretations and Policies:

.01 Principal Transactions: Order entry firms may not execute as principal against orders they represent as agent unless: (i) agency orders are first exposed on the Hybrid System for at least three (3) seconds, (ii) the order entry firm has been bidding or offering for at least (3) seconds prior to receiving an agency order that is executable against such bid or offer, or (iii) the order entry firm proceeds in accordance with the crossing rules contained in Rule 6.74. This paragraph also shall apply to orders resting on the Hybrid System in penny increments pursuant to Rule 6.13B. In such cases, agency orders priced in penny increments are deemed “exposed” pursuant to (i) above, and order entry firm orders priced in penny increments are deemed bids or offers pursuant to (ii) above.

.02 Solicitation Orders. Order entry firms must expose orders they represent as agent for at least three (3) seconds before such orders may be executed electronically via the electronic execution mechanism of the Hybrid System, in whole or in part, against orders solicited from members and non-member broker-dealers to transact with such orders. This paragraph also shall apply to agency orders resting on the Hybrid System in penny increments pursuant to Rule 6.13B. In such cases, agency orders priced in penny increments are deemed “exposed” pursuant to this paragraph.

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

6.45B Generally: No change.

(a)–(d) No change.

... Interpretations and Policies:

.01 Principal Transactions: Order entry firms may not execute as principal against orders they represent as agent unless: (i) agency orders are first exposed on the Hybrid System for at least three (3) seconds, (ii) the order entry firm has been bidding or offering for at least (3) seconds prior to receiving an agency order that is executable against such bid or offer, or (iii) the order entry firm proceeds in accordance with the crossing rules contained in Rule 6.74. This paragraph also shall apply to orders resting on the Hybrid System in penny increments pursuant to Rule 6.13B. In such cases, agency orders priced in penny increments are deemed “exposed” pursuant to (i) above, and order entry firm orders priced in penny increments are deemed bids or offers pursuant to (ii) above.

.02 Solicitation Orders. Order entry firms must expose orders they represent as agent for at least three (3) seconds before such orders may be executed electronically via the electronic execution mechanism of the Hybrid System, in whole or in part, against orders solicited from members and non-member broker-dealers to transact with such orders. This paragraph also shall apply to agency orders resting on the Hybrid System in penny increments pursuant to Rule 6.13B. In such cases, agency orders priced in penny increments are deemed “exposed” pursuant to this paragraph.

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Rule 6.47. Priority on Split-Price Transactions Occurring in Open Outcry

(a)-(c) No change.

. . . Interpretations and Policies:

.01 No change.

.02 The availability of split-price priority when an order is executed in a one-cent increment pursuant to Rule 6.13B shall be determined in accordance with Rule 6.13B(b).

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Rule 6.74. Crossing Orders

(a)-(f) No change.

. . . Interpretations and Policies:

.01-.08 No change.

.09 For purposes of paragraphs (a), (b), and (d), the minimum increment for bids and offers shall be one cent for orders that are subject to the open outcry penny price improvement under Rule 6.13B. Open outcry penny price improvement under Rule 6.13B shall not be available for orders executed pursuant to paragraphs (c) and (f).

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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.

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

1. Purpose

The purpose of this filing is to allow Exchange users the expanded ability to effect transactions in penny increments in classes and/or series trading on CBOE's Hybrid System that are not already quoting in penny increments.<sup>3</sup> The Exchange would designate the classes/series eligible for this penny pricing, and the penny pricing would be available electronically and in open outcry. As proposed, all limit orders electronically sent to CBOE (regardless of sender origin type) could be expressed in a one-cent increment. The Exchange would round the limit price to the nearest permissible quoted increment for display purposes, but would maintain the one-cent increment limit price for trade allocation purposes. For example, the CBOE market is 1 – 1.20 and an order is received to buy 10 contracts at 1.08. CBOE would disseminate a 1.05 bid for 10 contracts, and any subsequent sell market order received by the Exchange would trade at 1.08 for up to 10 contracts (after that, the quote would revert back to 1 – 1.20).<sup>4</sup>

An Exchange Market-Maker could also provide the Exchange with indications to trade in one-cent increments that improve on the Market-Maker's disseminated quotation. To the extent there is trading interest from multiple sources at the same one-cent increment price, priority will be established in the exact same manner as priority at a standard quoting increment (i.e., normal allocation procedures are used). The Exchange may attach an indicator to its publicly disseminated quote indicating the existence of penny pricing for the series, but the size and price

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<sup>3</sup> In File No. SR-CBOE-2006-42, the Exchange proposed to allow penny price improvement in open outcry. That filing has been withdrawn and most of its provisions have been incorporated into this filing, which also contemplates electronic penny price improvement.

<sup>4</sup> The Exchange has represented that the system would not execute an order at a price that would cause a trade-through of another options exchange.

of any penny pricing will not be displayed or made available to anyone. If the indicator feature is activated, it will apply to all classes/series participating in the penny pricing program.

With respect to open outcry, crowd members would be able to provide price improvement in one-cent increments over the Exchange's Best Bid or Offer ("BBO"). The Exchange has represented that any resulting trade would not cause a trade-through of another options exchange. Further, prior to executing any order in open outcry in one-cent increments, members would be required to electronically "sweep" any penny pricing interest that may exist. The "sweep" would ensure that better-priced orders resting in one-cent increments are executed prior to the open outcry transaction and would also ensure that same priced orders receive executions consistent with existing rules governing priority of orders in the Hybrid book when trading with an order represented in open outcry (CBOE Rules 6.45A(b) and 6.45B(b)).

The applicability of split-price priority under CBOE Rule 6.47 to transactions effected under proposed CBOE Rule 6.13B would be determined by the appropriate option procedure committee, and the mechanics of split-price priority in those instances would be the same as the mechanics of split-price priority in five-and ten-cent increments.

In addition, open outcry penny pricing would generally be available in instances where a Floor Broker is attempting to cross an order pursuant to CBOE Rule 6.74. However, it would not be available in those instances where (i) a Floor Broker is attempting to cross orders during the opening rotation in open outcry<sup>5</sup> or (ii) a Floor Broker is utilizing the Exchange's SizeQuote Mechanism.<sup>6</sup>

Lastly, the restrictions contained in Interpretations and Policies .01 and .02 under CBOE

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<sup>5</sup> See CBOE Rule 6.74(c), which provides procedures for a floor broker to cross orders during the opening rotation for a class of options.

<sup>6</sup> See CBOE Rule 6.74(f), which describes the SizeQuote Mechanism.

Rules 6.45A and 6.45B would continue to apply to trading in penny increments, including the 3-second exposure requirements, contained in those Interpretations and Policies.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>7</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>8</sup> in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, and, in general, to protect investors and the public interest. In particular, the Exchange believes that the proposal will provide an opportunity for customers to receive price improvement on their orders.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments on the proposed rule change were neither solicited nor received.

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 such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

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 No. SR-CBOE-2007-39 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 No. SR-CBOE-2007-39. 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 at <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 No. SR-CBOE-2007-39 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>9</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>9</sup> 17 CFR 200.30-3(a)(12).