

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55874; File No. SR-CBOE-2006-101)

June 7, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change as Modified by Amendment Nos. 1 and 2 Thereto to Amend CBOE's Rules to Reflect the Migration of its TPF Technology Platform Over to the Existing CBOEdirect Technology Platform.

I. Introduction

On November 30, 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")¹ and Rule 19b-4 thereunder,² a proposed rule change to introduce a third trading platform into its existing CBOEdirect system, "Hybrid 3.0." The Exchange submitted Amendment No. 1 to the proposed rule change on February 15, 2007. The Exchange submitted Amendment No. 2 to the proposed rule change on April 13, 2007.³ The proposed rule change, as modified by Amendment Nos. 1 and 2, was published for comment in the Federal Register on May 3, 2007.⁴ The Commission did not receive any comments regarding the proposal. This order approves the proposed rule change as modified by Amendment Nos. 1 and 2.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 2 replaced and superseded Amendment No. 1 and the original filing in their entireties.

⁴ Securities Exchange Act Release No. 55674 (April 26, 2007), 72 FR 24639 (May 3, 2007).

II. Description of the Proposal

In 2003, CBOE introduced the Hybrid Trading System (“Hybrid” or “Hybrid System”), an electronic trading platform integrated with CBOE’s floor-based open-outcry auction market.⁵ Under CBOE’s existing rules, the Hybrid System currently supports two trading platforms: (i) the original Hybrid Trading System, which is a trading platform that allows individual Market-Makers to submit electronic quotes in their appointed classes; and (ii) Hybrid 2.0, which is an enhanced trading platform that allows remote quoting by authorized categories of Exchange members. These two platforms operate on a technology system that is referred to as the CBOEdirect trade engine. In addition to these two platforms, prior to 2003 and through the present, CBOE has also utilized its TPF mainframe system to support trading in its “non-Hybrid” classes.⁶ Therefore, options classes currently may be authorized by the Exchange to trade on the non-Hybrid, original Hybrid Trading System or Hybrid 2.0 platforms.

CBOE has determined to migrate the trading programs operating on its TPF mainframe system to the CBOEdirect trade engine. To accommodate this changeover, CBOE has proposed to amend its Hybrid rules to introduce a third trading platform into its existing CBOEdirect system, called “Hybrid 3.0,” which incorporates certain aspects of both the Hybrid Trading System and non-Hybrid platforms. The more significant aspects of the proposal are outlined below.⁷

⁵ See Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003).

⁶ The three current non-Hybrid classes are options: on the S&P 100 Index – OEX; options on the S&P 500 Index – SPX; and options on the Morgan Stanley Retail Index – MVR.

⁷ To incorporate Hybrid 3.0 into CBOE’s existing Hybrid rules, CBOE has proposed to define all references to “Hybrid,” “Hybrid System,” and “Hybrid

A. Quoting

As proposed, the Hybrid 3.0 platform will allow a single electronic quote, which will represent the aggregate Market Maker quoting interest in each option series for the trading crowd (“Hybrid 3.0 crowd quote”). This single quote will be generated from either an appointed Designated Primary Market Maker (“DPM”) or Lead Market Maker (“LMM”). In this way, Hybrid 3.0 will operate in a manner similar to the existing non-Hybrid platform where an appointed DPM or LMM may generate an automated quote for the trading crowd.⁸

In Hybrid 3.0, members of the trading crowd will be able to submit manual quotes. Specifically, members of the trading crowd will be able to verbalize manual quotes to be input into Exchange systems by quote reporters for dissemination to the Options Price Reporting Authority (“OPRA”).⁹ The manual quote disseminated in Hybrid 3.0 classes will be separate and additional to the Hybrid 3.0 crowd quote. If market participants (which include in-crowd market makers) are eligible to submit orders for entry into the electronic book, then the appropriate Procedure Committee may determine to disable manual quotes.¹⁰

Trading System” in CBOE’s rules to mean all CBOE hybrid platforms, including Hybrid 3.0, unless otherwise provided by a specific CBOE rule.

⁸ Currently, the non-Hybrid platform allows for the use of an Exchange-sponsored autoquote system. However, according to CBOE, this functionality will not be available for Hybrid 3.0.

⁹ Similar to the existing functionality for manual quotes in non-Hybrid classes, in Hybrid 3.0 the Exchange’s disseminated OPRA quote will not distinguish between electronic and manual quotes but members of the trading crowd will be able to distinguish between electronic and manual quotes.

¹⁰ A market participant is defined as a “Market-Maker, a Remote Market-Maker, an in-crowd DPM or LMM, an e-DPM with an appointment in the subject class, and

B. Order Eligibility for Entry into Electronic Book

In Hybrid 3.0, public customer orders are automatically eligible for electronic book entry.¹¹ Moreover, in Hybrid 3.0, the appropriate Procedure Committee can determine, on a class by class basis, to allow certain other types of orders into the electronic book, including orders of market participants and broker-dealers.¹² These eligibility rules are the same as the existing rules for other Hybrid classes except that, with respect to other Hybrid classes, market participants are eligible to submit orders for entry into the electronic book without the appropriate Procedure Committee’s approval. The proposed electronic book eligibility rules for Hybrid 3.0 are consistent with current practices in CBOE’s non-Hybrid classes.¹³

C. Automatic Execution of Incoming Orders

Hybrid 3.0 proposes to permit automatic execution of non-broker-dealer public customer orders. In addition, the appropriate Procedure Committee may determine, on a class by class basis, to allow orders of broker-dealers that are not market-makers or specialists on an exchange who are exempt from the provisions of Regulation T of the Federal Reserve Board pursuant to Section 7(c)(2) of the Act (“non-Market-Maker or non-Specialist broker-dealers”) to be eligible for automatic execution.¹⁴

a floor broker or PAR Official representing orders in the trading crowd.” See CBOE Rule 6.45B.

¹¹ See CBOE Rule 7.4(a)(1).

¹² Id.

¹³ See CBOE Rule 6.8.01.

¹⁴ See proposed changes to CBOE Rule 6.13(b)(i)(C)(i). This process is consistent with the appropriate Procedure Committee’s ability to permit broker-dealer orders to be automatically executed through the Exchange’s Retail Automatic Execution System (“RAES”) in CBOE’s non-Hybrid Classes. See CBOE Rule 6.8.01.

For Hybrid 3.0 classes, incoming orders that are eligible to receive automatic execution will execute against public customer orders in the electronic book. The remaining balance of the incoming order, if any, may be (i) represented in the electronic book provided such order is eligible for book entry¹⁵ or (ii) if the order is not eligible for book entry, it will route to PAR, BART, or to the order entry firm's booth printer.

On the Hybrid 3.0 platform, automatic execution against quotes (whether electronic or manual) will not be allowed.¹⁶ However, if the electronic book price matches a manual quote, then automatic execution will be permissible against public customer orders in the electronic book.¹⁷ CBOE represented that, consistent with existing practices in CBOE's non-Hybrid Classes, the Exchange will apply similar firm quote surveillance procedures in Hybrid 3.0 to monitor for compliance with members' firm quote obligations.

D. Application of CBOE Rule 6.45B

CBOE Rule 6.45B, which relates to the priority and allocation of trades, will apply to trading in Hybrid 3.0 classes in the same way it is applied to CBOE's existing

¹⁵ Even if an order is eligible for book entry, the order entry firm will have the discretion to have the remaining balance of the eligible order route to PAR, BART, or to the order entry firm's booth printer.

¹⁶ See CBOE Rule 6.13. By comparison, currently in CBOE's non-Hybrid Classes, orders may be eligible for automatic execution against market maker quotes on RAES. See CBOE Rules 6.8 and 24.17. The Exchange represents that the number of trades that occur on RAES is minimal (approximately 1/10th of 1% of all volume occurs on RAES).

¹⁷ See proposed changes to CBOE Rule 6.43(b). For example, if the electronic book is a \$1.20 bid and the manual quote is at a \$1.20 bid, then the system will allow for automatic execution against the \$1.20 electronic book bid but not the \$1.20 quote. In addition, if the Hybrid 3.0 crowd quote matches the electronic book price, automatic execution against public customer orders in the book is permissible.

Hybrid Trading System. For example, multiple customer orders in the electronic book at the same price will be ranked based on time priority pursuant to the priority methods set forth in Rule 6.45B.¹⁸ Further, unlike CBOE’s non-Hybrid classes, Hybrid 3.0 will allow (i) each Market-Maker in the trading crowd and (ii) all floor brokers in the trading crowd (collectively referred to as “in-crowd market participants” or “ICMPs”) to trade against the electronic book pursuant to CBOE Rule 6.45B(c).¹⁹

CBOE Rule 6.45B(d) currently governs the interaction of quotes when they are locked (e.g., \$1.00 bid – 1.00 offer). Specifically, CBOE Rule 6.45B(d) provides that when the quotes of two Market-Makers interact (i.e., “quote lock”), either party has one second during which it may move its quote without obligation to trade with the other party. If, however, the quotes remain locked at the conclusion of one-second, the quotes trade in full against each other. For quote locks in Hybrid 3.0 classes, the appropriate Procedure Committee will set the length of the counting period, provided that the period shall not exceed ten seconds.²⁰ According to the Exchange, the proposed ten second threshold is intended to provide additional flexibility for Market-Makers to become acclimated with Hybrid 3.0.²¹

Regarding the time periods required for order exposure in Interpretation .01 of Rule 6.45B (“Principal Transactions”) and Interpretation .02 of Rule 6.45B (“Solicitation Orders”), CBOE has proposed a minimum exposure time for Hybrid 3.0 classes, on a

¹⁸ See CBOE Rule 6.45B(a)(ii)(A)(1).

¹⁹ This process is the same as for existing Hybrid classes.

²⁰ See proposed changes to CBOE Rule 6.45B(d).

²¹ By comparison, the current quote lock timer for Hybrid and Hybrid 2.0 classes may not exceed one second. See CBOE Rule 6.45B(d)(i)(C).

class by class basis, to be at least three seconds but not to exceed thirty seconds.²²

According to CBOE, this extended time frame for exposure will provide additional flexibility as ICMPs become more acclimated with Hybrid 3.0.²³

E. Opening Procedures

Only the DPM or LMM responsible for generating the Hybrid 3.0 crowd quote will be required to enter quotes as part of the opening rotations in Hybrid 3.0 option classes. The DPM or LMM must enter opening quotes in opening rotations that comply with the legal quote width requirements of Rule 8.7(b)(iv), and if there is not a quote present in a series that complies with the legal quote width requirements of Rule 8.7(b)(iv), then that series will not open.²⁴ Additionally, Hybrid 3.0 will allow public customer, broker-dealer, Exchange Market-Maker, away Market-Maker and Specialist participation in the opening. Since Hybrid 3.0 is a single quoter environment, these participants will not be permitted to enter opening quotes in opening rotations but will be permitted to directly enter opening orders in opening rotations in Hybrid 3.0 classes.²⁵ Further, similar to the rules for CBOE's non-Hybrid classes, Hybrid 3.0 also proposes to

²² See proposed changes to CBOE Rule 6.45B.01 and 6.45B.02.

²³ By comparison, the current exposure period for Hybrid and Hybrid 2.0 classes is at least three seconds. See CBOE Rule 6.45B.01 and 6.45B.02.

²⁴ This is consistent with the opening quote requirements in CBOE's existing Hybrid classes that utilize CBOE's Hybrid Opening System ("HOSS"). See CBOE Rule 6.2B.

²⁵ See proposed Interpretation .01 to CBOE Rule 6.2B. By comparison, currently in non-Hybrid option classes (such as SPX and OEX), public customers, Market-Makers and broker-dealers are not able to directly participate in the opening rotations (for series that utilize the Exchange's Rapid Opening System). For example, Market-Makers who wish to participate on ROS in the opening rotation in non-Hybrid option classes must submit orders through the LMM at least ten minutes prior to the opening of trading pursuant to CBOE Rules 6.2A and 24.13.

allow special “modified” opening procedures for settlement in options on the Volatility Indexes.²⁶

III. Discussion

The Commission has reviewed carefully the proposed rule change, as amended, and finds that it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.²⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²⁸ which requires that an exchange have rules designed, among other things, to promote just and equitable principles of trade, 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 proposed rules for Hybrid 3.0 are similar to existing rules applicable to trading in Hybrid and/or non-Hybrid classes. The Commission believes that the proposed rules for the Hybrid 3.0 platform, including those pertaining to quoting, order eligibility in the electronic book, automatic execution, order priority and allocation, are consistent with the Act.

²⁶ See the “Modified HOSS Opening Procedures” in proposed Interpretation .01 to CBOE Rule 6.2B. By comparison, non-Hybrid option classes that utilize RAES and ROS have special procedures for purposes of settlement in the volatility indexes called “Modified ROS Opening Procedures” pursuant to Interpretation .03 to CBOE Rule 6.2A.

²⁷ In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁸ 15 U.S.C. 78f(b)(5).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁹ that the proposed rule change as modified by Amendment Nos. 1 and 2 thereto (File No. SR-CBOE-2006-101) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant delegated authority.³⁰

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Deputy Secretary

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).