

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60018; File No. SR-CBOE-2009-031)

June 1, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change Amending CBOE Rules Relating to the Penny Pilot Program

Pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (the “Act”)² and Rule 19b-4 thereunder,³ notice is hereby given that, on May 28, 2009, the Chicago Board Options Exchange, Incorporated (“CBOE” or the “Exchange”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been 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 is proposing to amend CBOE rules relating to the Penny Pilot Program.

The text of the rule proposal is available on the Exchange’s Web site

(<http://www.cboe.org/legal>), at the Exchange’s Office of the Secretary and at the Commission’s Public Reference Room.

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

In its filing with the Commission, the self-regulatory organization 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

¹ 15 U.S.C.78s(b)(1).

² 15 U.S.C. 78a.

³ 17 CFR 240.19b-4.

specified in Item IV below. CBOE has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

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

1. Purpose

CBOE proposes to extend and expand the Penny Pilot Program, which commenced on January 26, 2007. Presently, the Penny Pilot Program is in effect in fifty-eight multiply-listed option classes, representing approximately 53% of the national volume in April 2009.⁴ For all classes in the Program except for the QQQQs, the minimum increment for bids and offers is 0.01 for all option series below \$3 (including LEAPS), and \$0.05 for all option series \$3 and above (including LEAPS). For QQQQs, the minimum increment is \$0.01 for all option series. The Penny Pilot Program is scheduled to expire on July 3, 2009.

During the course of the Penny Pilot, CBOE has thoroughly analyzed the impact of penny quoting in the Pilot classes, including in such areas as average spread, average size, quote message traffic, and industry volume. CBOE has submitted several reports to the SEC describing the impact of the changes to the minimum increments in the Pilot classes, and has identified various trends that have manifested themselves.⁵ These trends include: a significant reduction in liquidity at the BBO; a decrease in volume in some classes⁶; a dramatic rise in quote

⁴ CBOE's rules also provide that for so long as SPDR options (SPY) and options on Diamonds (DIA) participate in the Penny Pilot Program, the minimum increments for Mini-SPX Index Options (XSP) and options on the Dow Jones Industrial Average (DJX), respectively, are \$0.01 for all option series below \$3, and \$0.05 for all option series \$3 and above. See CBOE Rule 6.42.03.

⁵ CBOE has submitted five reports analyzing the Penny Pilot Program. See letters from CBOE's President Edward Joyce to Elizabeth King, dated June 1, 2007, November 1, 2007, March 4, 2008, September 4, 2008, and March 9, 2009.

⁶ CBOE recognizes that it is difficult to discern the extent to which the reduction in volume in some Pilot classes may be attributable to the Penny Pilot, as opposed to some

traffic; and a reduction in average spread width. With respect to quote traffic, five of seven options exchanges have set all-time peak message rates thus far in 2009, three of which occurred in the past three weeks.

In an effort to develop a long-term solution to the issue of penny pricing in options, last March 2008 CBOE proposed that the industry adopt a structure whereby option series of less than \$1 premium value are quoted in penny increments, and series at \$1 or above quoted in nickel increments. CBOE has explained the advantages of its proposal, which include:

- Providing the benefits of penny quoting and trading in those option contracts that customers actually trade. 61% of customer contract volume is in series priced up to \$1. In the Penny Pilot classes, 52% of customer contract volume is in series priced up to \$1;
- Introducing penny increments in nearly all listed option classes;
- Reducing the current dime increment to nickels in those same classes for series priced \$1 and above;
- Helping to reduce the explosion of quote traffic that would otherwise occur if the current \$3 breakpoint was maintained as part of a large expansion;
- Providing a simple and easily understood standard for investors as to which options are quoted in penny increments; and
- Providing flexibility in that if it is determined that the benefits of penny quoting at a breakpoint higher than \$1 outweigh any negatives, modifying the breakpoint would be fairly easy to implement.

combination of the Penny Pilot and market conditions overall and/or conditions in a particular security.

CBOE's proposal to reduce the \$3 breakpoint to \$1 for the Penny Pilot classes has been endorsed by the Equity Options Committee of SIFMA, which has stated that "retail order flow is far more likely to concentrate activity in low premium options as opposed to those with much larger premium levels."⁷ CBOE reiterated its long-term solution to the issue of penny pricing in options in its September 4, 2008, and March 9, 2009 Penny Pilot Report to the SEC.

CBOE believed then and continues to believe that developing a long-term solution is necessary so that the exchanges, its members, market data vendors, and other market participants can make informed decisions regarding systems and capacity planning. Accordingly, CBOE proposes to extend the Pilot Program through December 31, 2010. CBOE also proposes to significantly expand Pilot Program to all equity and ETF option classes, such that at the end of a brief roll-out period all equity and ETF option classes would be included in the Penny Pilot Program. Moreover, in all Pilot classes, option series of less than \$1 premium value would be quoted in penny increments, and series at \$1 or above would be quoted in nickel increments. Specifically, CBOE proposes the following⁸:

- Extend the existing Penny Pilot Program until 60 days following SEC approval of this rule change, at which time the minimum increment "breakpoint" would be reduced from \$3 to \$1 in all Penny Pilot classes, such that all option series of less than \$1 premium value are quoted in penny increments with all series \$1 and above quoted in nickel increments. Although all series in the QQQQ currently are quoted in penny increments, CBOE believes that the same \$1 breakpoint standard should apply in the QQQQs as

⁷ See letter from Melissa MacGregor, Vice President and Assistant General Counsel, SIFMA, to Elizabeth King dated March 10, 2008.

⁸ The proposed roll-out schedule assumes that the new Linkage will be implemented in the 3rd quarter of 2009, and that this proposed rule change is approved on or about July 1, 2009.

well.⁹

- 90 days following SEC approval of this rule change, an additional forty-two classes would be added to the Penny Pilot Program bringing the total number of classes in the Pilot Program to 100. These forty-two new classes would be among the most active, multiply-listed equity and ETF option classes that are not currently in the Pilot Program.
- 120 days following SEC approval of this rule change, an additional 200 option classes would be added to the Penny Pilot Program bringing the total number of classes in the Pilot Program to 300. These 200 new classes would be among the most active, multiply-listed equity or ETF option classes that are not currently in the Pilot Program.
- 150 days following SEC approval of this rule change, an additional 400 option classes would be added to the Penny Pilot Program bringing the total number of classes in the Pilot Program to 700. These 400 new classes would be among the most active, multiply-listed equity or ETF option classes that are not currently in the Pilot Program.
- 180 days following SEC approval of this rule change, all remaining equity and ETF option classes would be added to the Penny Pilot Program.

The above roll-out schedule contemplates the launch of the new Linkage Plan, which is scheduled to occur in the 3rd quarter of 2009, prior to any expansion of the Penny Pilot Program. CBOE believes strongly the new Linkage Plan should be implemented before a significant expansion occurs because intermarket sweep orders (ISOs) will be available in the new Linkage Plan, and thus allow market participants to simultaneously access better priced quotations across all options exchanges. The new option classes to be added to the Pilot Program would be identified based on national average daily volume in the six calendar months prior to the date the

⁹ The minimum increment breakpoint for XSP options and DJX options similarly would be reduced from \$3 to \$1. See CBOE Rule 6.42.03.

classes are added to the Program.¹⁰ CBOE will work jointly with the SEC to identify the option classes to be added to the Pilot Program and to determine the exact dates the classes will be added, and will submit proposed rule changes pursuant to Section (b)(3)(A) of the Exchange Act announcing the names of the new classes prior their being added to the Pilot Program in each of the phases mentioned above.¹¹ Based on the proposed roll-out described above, CBOE anticipates that all equity and ETF option classes would be included in the Penny Pilot Program by early 2010.

CBOE also will submit to the SEC semi-annual reports analyzing the Penny Pilot Program for the following time periods:

- July 1, 2009 – December 31, 2009
- January 1, 2010 – June 30, 2010
- July 1, 2010 – December 31, 2010

CBOE anticipates that its reports will assess the impact of the changes to the minimum increments during the specific time period being analyzed, including, among other things, effects on (i) market participants and customers; (ii) market performance and quality, such as quoted spreads, effective spreads, and the displayed size in the Pilot classes; and (iii) OPRA, vendor and exchange capacity. CBOE's reports will be submitted within one month following the end of the period being analyzed.

CBOE believes that extending and expanding the Penny Pilot Program as proposed is balanced, responsible, and reasonable. It will benefit investors by expanding the Pilot Program in all equity and ETF option classes over a relatively short period of time, which will enable

¹⁰ CBOE would use volume data from the Options Clearing Corporation.

¹¹ CBOE also intends to issue a Regulatory Circular, which will be published on its website, identifying these option classes added to the Pilot Program.

investors to obtain the benefits of penny quoting and trading in those option contracts that customers actually trade. The proposal is balanced in that recognizes that the Pilot Program, while providing certain clear benefits such as reducing spreads, also has resulted in a significant reduction in liquidity at the BBO, a decrease in volume in some classes, and a significant rise in quote traffic. Moreover, CBOE's plan eliminates investor confusion as to which options are quoted in penny increments, and helps to reduce the growth of quote traffic.

2. Statutory Basis

The Exchange believes the rule proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 ("Act") and the rule and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.¹² Specifically, the Exchange believes that the proposed rule change is consistent with the Section 6(b)(5) Act¹³ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest. The Exchange believes that expanding the current Penny Pilot Program as proposed will enable investors to obtain the benefits of penny quoting and trading in those option contracts that customers actually trade. It will also eliminate investor confusion as to which options are quoted in penny increments, and help to reduce the growth of quote traffic.

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

CBOE 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

¹² 15 U.S.C. 78f(b).

¹³ 15 U.S.C. 78f(b)(5).

The Exchange neither solicited nor received comments on the proposal.

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 self-regulatory organization consents, the Commission will:

(A) By order approve such 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. In addition, the Commission seeks comment on the following issues:

1. The Commission requests comment generally on the impact on quote capacity, if any, were the Commission to approve SR-NYSEArca-2009-44, NYSE Arca's proposal to expand the Penny Pilot program to include the next 300 most actively traded, multiply listed options classes over four successive quarters, in addition to this proposed rule change.

2. The Commission requests comment on the impact, if any, to market participants' technological systems and platforms to accommodate the proposed change in breakpoint at \$1.00 applied to all option classes.

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-2009-031 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2009-031. 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing will also be available for inspection and copying at the principal office of the self-regulatory organization. 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-2009-031 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁴

Florence E. Harmon
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).