

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61198; File No. SR-CBOE-2009-078)

December 17, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of the Proposed Rule Change, as Modified by Amendment No. 1, Related to Professional Orders

I. Introduction

On October 20, 2009, the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder² to amend its order execution rules to give certain non-broker-dealer orders the same priority as broker-dealer orders. On November 3, 2009, the Exchange filed Amendment No. 1 to the proposal.³ The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on November 12, 2009.⁴ The Commission received three comment letters on the proposal.⁵ This order approves the proposal, as modified by Amendment No. 1.

II. Description of CBOE’s Proposal

CBOE proposes to adopt a new term, “Professional,” which would be defined in proposed CBOE Rule 1.1(ggg) as a person or entity that (i) is not a broker or dealer in securities,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 revised a paragraph in the Purpose section of the proposal relating to the application of Section 11(a) of the Act.

⁴ See Securities Exchange Act Release No. 60931 (November 4, 2009), 74 FR 58355 (November 12, 2009) (“Notice”).

⁵ See letters from Charles B. Cox, dated November 11, 2009 (“Cox Letter”); Richard Weinstock, dated November 24, 2009 (“Weinstock Letter I”); and Richard Weinstock, dated December 3, 2009 (“Weinstock Letter II”).

and (ii) places more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s).⁶ The definition would state that a Professional will be treated in the same manner as a broker or dealer in securities for purposes of specified order execution rules of CBOE.⁷

The use of this new term for purposes of these rules would result in Professionals participating in CBOE's allocation process on equal terms with broker-dealers – i.e., Professionals would not receive priority over broker-dealers in the allocation of orders on the Exchange. CBOE states that the proposal would not otherwise affect non-broker-dealer

⁶ The Professional designation would not be available in Hybrid 3.0 classes.

⁷ Specifically, the orders of Professionals would be treated like broker-dealer orders for the purposes of CBOE Rules 6.2A (Rapid Opening System), 6.2B (Hybrid Opening System), 6.8C (Prohibition Against Members Functioning as Market-Makers), 6.9 (Solicited Transactions), 6.13A (Simple Auction Liaison), 6.13B (Penny Price Improvement), 6.45 (Priority of bids and Offers – Allocation of Trades), 6.45A (Priority and Allocation of Equity Option Trades on the CBOE Hybrid System) (except that Professional orders may be considered public customer orders, and therefore not be subject to the exposure requirements for solicited broker-dealer orders, under Interpretation and Policy .02), 6.45B (Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System) (except that Professional orders may be considered public customer orders, and therefore not be subject to the exposure requirements for solicited broker-dealer orders, under Interpretation and Policy .02), 6.53C(c)(ii) and (d)(v) and 6.53C.06(b) and (c) (Complex Orders on the Hybrid System), 6.74 (Crossing Orders) (except that Professional orders may be considered public customer orders subject to facilitation under paragraphs (b) and (d)), 6.74A (Automated Improvement Mechanism) (except Professional orders may be considered customer Agency Orders or solicited orders eligible for customer-to-customer immediate crosses under Interpretation and Policy .09), 6.74B (Solicitation Auction Mechanism), 8.13 (Preferred Market-Maker Program), 8.15B (Participation Entitlement of LMMs), 8.87 (Participation Entitlement of DPMs and e-DPMs), 24.19 (Multi-Class Broad-Based Index Option Spread Orders), 43.1 (Matching Algorithm/Priority), 44.4 (Obligations of SBT Market-Makers), and 44.14 (SBT DPM Obligations).

individuals or entities under CBOE rules, and that, in particular, all public customer orders would continue to be treated equally for purposes of rules relating to options exchange linkage.⁸

In addition, CBOE intends to require members to indicate whether public customer orders are “Professional” orders to assure that orders entered on the Exchange are properly represented.⁹ To comply with this requirement, members would be required to review their customers’ activity on at least a quarterly basis to determine whether orders that are not for the account of a broker or dealer should be represented as public customer orders or as Professional orders.¹⁰

The Exchange states that it intends to establish, in a separate rule filing, transaction fees applicable to Professionals, and that it would not commence the implementation of the instant proposal until such fees are in place.¹¹

IV. Commission Findings and Order Granting Approval of the Proposed Rule Change Change as Modified by Amendment No. 1

After careful consideration of the proposed rule change and the comments received, the Commission finds that the proposed rule change is consistent with the Act. Specifically, the

⁸ See CBOE Rules 6.14A and 6.80-6.82, which relate to routing of orders and linkage. These rules are not included by the proposed rule change in the list of rules, supra, for which the Professional designation would apply.

⁹ CBOE has issued a regulatory circular outlining the procedures for the implementation of the proposal. See CBOE Regulatory Circular RG09-123 (November 6, 2009).

¹⁰ Id.

¹¹ See Notice, supra note 4.

Commission finds that the proposed rule change is consistent with Section 6(b)¹² of the Act and the rules thereunder,¹³ and in particular with:

Section 6(b)(5) of the Act, which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers;¹⁴ and

Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or appropriate in furtherance of the Act.¹⁵

In addition, the Commission finds that the proposed rule change is consistent with Section 11(a) of the Act.¹⁶

Under the proposed rule change, public customers would be deemed “Professional” and would no longer receive the priority treatment currently granted to all public customers, if they place orders on the level of frequency specified in proposed Rule 1.1(ggg). In January 2009, the Commission approved a similar rule proposed by the International Securities Exchange, LLC (“ISE”) to create the category of “Professional Orders,” and to include in that category – in addition to the orders of broker-dealers – the orders of public customers who place on average more than 390 orders per day in a calendar month. Under the ISE rule, public customer orders

¹² 15 U.S.C. 78f(b).

¹³ In approving the proposed rule change, the Commission notes that it 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).

¹⁵ 15 U.S.C. 78f(b)(8).

¹⁶ 15 U.S.C. 78k(a).

that satisfied the criteria for Professional Orders were no longer to be accorded the priority granted to the orders of other public customers (i.e., “Priority Customers”).¹⁷ While the proposed CBOE rule differs somewhat from the format of the ISE rule, the Commission believes that the CBOE proposal is comparable to the ISE rule pertaining to Professional Orders, which the Commission found to be consistent with the Act.

In the ISE Approval Order, the Commission reviewed the background and history of customer order priority rules on national securities exchanges, and analyzed the role played in the shaping of these rules by various considerations and principles. In this regard, the Commission discussed the requirement of Section 6(b)(5) of the Act that the rules of an exchange be designed to protect investors and the public interest; traditional notions of customer priority in exchange trading; the agency obligations of exchange specialists; and the requirements of Section 11(a) of the Act.¹⁸ In approving the ISE proposal, the Commission articulated its view that priority for public customer orders is not an essential attribute of an exchange,¹⁹ and noted that in the past it has approved trading rules at options exchanges that do not give priority to orders of public customers that are priced no better than the orders of other market participants.²⁰

The Commission concluded in the ISE Approval Order that Section 6(b)(5) of the Act does not require an exchange to treat the orders of public customers who place orders at the frequency of more than 390 orders per day on average identically to the orders of public

¹⁷ See Securities Exchange Act Release No. 59287 (January 23, 2009), 74 FR 5694 (January 30, 2009) (“ISE Approval Order”).

¹⁸ ISE Approval Order, supra note 17. For a brief synopsis of the requirements of Section 11(a), see infra, note 21.

¹⁹ See ISE Approval Order, supra note 17, at 5697.

²⁰ ISE Approval Order, supra note 17, at 5697, n. 41-44

customers who do not meet that threshold. For the same reason, the Commission believes that the CBOE's proposed rule change is consistent with Section 6(b)(5) of the Act.

With regard to Section 11(a) of the Act,²¹ the Exchange states that it does not believe that the proposal would affect the availability of the exceptions to Section 11(a) of the Act, including the exceptions in subparagraph (G) of Section 11(a) and in Rules 11a1-1(T) and 11a2-2(T), as are currently available.²² The Commission concurs. For this reason, the Commission believes that the proposed rule change, which would permit orders of CBOE members to be executed under certain circumstances even if an order of a Professional is on CBOE's book, is consistent with the requirements of Section 11(a) of the Act.

As noted above, the Commission received three comment letters from two commenters regarding the proposed rule change, both of whom opposed the proposal.²³ The commenters believed, among other things, that the proposal would thwart competition²⁴ and that the proposal was designed for that purpose.²⁵ They further believed that the proposal would discourage and impede customers who provide valuable liquidity to the market and whose participation

²¹ Section 11(a) prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion unless an exception applies. Section 11(a)(1) and the rules thereunder contain a number of exceptions for principal transactions by members and their associated persons, including the exceptions in subparagraph (G) of Section 11(a)(1) and in Rule 11a1-1(T), as well as Rule 11a2-2(T) under the Act, 17 CFR 240.11a2-2(T).

²² See Notice, supra note 4 at n.17 and accompanying text. See also Securities Exchange Act Release No. 59546 (March 10, 2009), 74 FR 11144 (March 16, 2009)(SR-CBOE-2009-016) and related CBOE regulatory circular, RG09-35, in which CBOE provides its members with information on compliance with Section 11(a)(1) when trading on CBOE's Hybrid System.

²³ See supra note 5.

²⁴ See Cox Letter, Weinstock Letters I and II.

²⁵ See Weinstock Letters I and II.

promotes price discovery.²⁶ In addition, they argued that it is unfair to treat public customers in the same manner as members of the Exchange are treated, because public customers do not have the same marketplace advantages as members.²⁷ One of the commenters added that the threshold of 390 orders per day was arbitrary and capricious and that the proposal does not make clear that orders placed at other exchanges are to be included in determining whether the 390-order threshold has been reached.²⁸

The arguments and concerns raised by the commenters are similar to the arguments and concerns that were raised by commenters on the ISE proposal. The Commission believes, as it stated with respect to the ISE proposal, that these arguments and concerns do not support the conclusion that the proposal is inconsistent with the Act.

The Commission believes that its views with respect to the ISE proposal are equally applicable to the CBOE proposal. In this regard, the Commission does not believe that the Act requires that the order of a public customer or any other market participant be granted priority. Historically, in developing their trading and business models, exchanges have adopted rules, with Commission approval, that grant priority to certain participants over others, in order to attract order flow or to create more competitive markets. However, the Act does not entitle any participant to priority as a right. The requirement of Section 6(b)(8) of the Act that the rules of an exchange not impose an unnecessary or inappropriate burden upon competition does not necessarily mandate that a Professional (as defined in the CBOE proposal) be granted priority at

²⁶ See Weinstock Letters I and II. Both Weinstock Letters and the Cox Letter maintained that the additional liquidity provided by customers improves price discovery when such customers receive priority, particularly in the context of penny pricing.

²⁷ See, in particular, Weinstock Letter I, which pointed to advantages of time and place, different capital requirements, and the ability of market makers to quote on both sides of the market.

²⁸ See Weinstock Letter I.

a time that a broker-dealer is not granted the same right. The CBOE proposal simply restores the treatment of persons who would be deemed Professionals to a base line where no special priority benefits are granted.

The Commission agrees that public customers provide valuable liquidity to the options markets and compete with market makers. However, the contribution of these participants to the market does not mean that their orders are entitled to priority treatment, even if – as the commenters argue – they would not be able to supply this liquidity without being granted such advantage. Market makers and broker-dealers also provide valuable liquidity to the marketplace and do not have priority.

With respect to the contention that broker-dealers have substantial marketplace advantages over public customers, it should be noted that broker-dealers, unlike public customers, pay significant sums for registration and membership in self-regulatory organizations (“SROs”), and incur significant costs to comply, and to ensure that their associated persons comply, with the Act, the rules thereunder, and SRO rules. Moreover, persons who place options orders on the scale contemplated by the proposal could choose to become registered broker-dealers and receive the same advantages.

Regarding the contention of one commenter that the numerical threshold is arbitrary, the Commission believes that it is reasonable to establish the placement of one order every minute on average as a threshold to establish the level of activity, at a minimum, at which the Exchange believes that the incentive of priority is not warranted. For the same reason, the Commission does not believe that such a threshold is capricious.

Finally, the Commission believes that the proposed rule change is clear in not distinguishing between orders placed on the CBOE and those placed on any other exchange, and

CBOE stated that “basing the standard on the number of orders that are entered in listed options for a beneficial account(s) assures that Professional account holders cannot inappropriately avoid the purpose of the rule by spreading their trading activity over multiple exchanges.”²⁹

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁰ that the proposed rule change (SR-CBOE-2009-078), as modified by Amendment No. 1, be, and it hereby is, approved.

Florence E. Harmon
Deputy Secretary

²⁹ See Notice, *supra* note 4.

³⁰ 15 U.S.C. 78s(b)(2).