

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62317; File No. SR-CBOE-2010-038)

June 17, 2010

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Related to the Hybrid Matching Algorithms

On April 22, 2010, 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 revise its market maker and modified participation entitlement priority overlays. On May 6, 2010, CBOE filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on May 18, 2010.³ The Commission received no comment letters on the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

CBOE Rules 6.45A (Priority and Allocation of Equity Option Trades on the CBOE Hybrid System), and 6.45B (Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System) set forth, among other things, the manner in which incoming electronic orders in options are allocated on the Hybrid System. Each rule currently provides allocation algorithms the Exchange can utilize when executing incoming electronic orders, including the Ultimate Matching Algorithm (“UMA”), and price-time and pro-rata priority allocation algorithms. The price-time and pro-rata priority overlays currently include: public customer priority for public customer orders resting on the Hybrid System; participation

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 62083 (May 12, 2010), 75 FR 27850.

entitlements for certain qualifying market-makers (the “original participation entitlement(s)”); a market turner priority for participants that are the first to improve CBOE’s disseminated quote; and a modified participation entitlement overlay⁴ in which the original participation entitlement would apply only if there are no public customer orders resting at the best price or a public customer was the first to rest interest at the best price. In addition, a small order participation entitlement overlay for Designated Primary Market-Makers (“DPMs”) and Lead Market-Makers (“LMMs”) can be applied to each of the three allocation algorithms (i.e., price-time, pro-rata or UMA).⁵ These overlays are all optional.

The proposed rule change would amend the Exchange’s priority overlays. CBOE proposes to make the market turner overlay available for classes utilizing any of the priority methods offered by the Exchange. The Exchange also proposes to amend the application of the modified participation entitlement overlay. Under the proposal, a Market-Maker that is the subject of a participation entitlement would only receive an entitlement if the amount it is entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the algorithm. In all other cases, the participation entitlement and public customer priority would not be applied. This allocation would be subject to the following:

- The Market-Maker’s entitlement share would be calculated based on any remaining balance after all public customer orders at the best price are satisfied. For options

⁴ Securities Exchange Act Release No. 60665 (September 14, 2009), 74 FR 48114 (September 21, 2009) (SR-CBOE-2009-052).

⁵ If the small order priority overlay is in effect for an option class, then orders for five (5) contracts or fewer will be executed first by the DPM or LMM, as applicable, appointed to the option class. This participation entitlement is subject to certain conditions, including a condition that public customer priority must be in effect in priority sequence ahead of the participation entitlement. See Rules 6.45A(a)(iii) and 6.45B(a)(iii).

classes using the pro-rata method, the Exchange may determine on a class-by-class basis to calculate the Market-Maker's entitlement share using the UMA methodology or the pro-rata methodology. For options classes using the price-time method, the Market-Maker's entitlement share would be calculated using the price-time methodology only.⁶

- When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, the participation entitlement and public customer priority overlays would not be considered. Instead the calculation would be based on a price-time or pro-rata basis, as applicable, and subject to any other applicable priority overlays, such as market turner priority.

In addition, the Exchange proposes that the modified participation entitlement overlay would be available to modify the application of the small order participation entitlement.

The Commission has carefully reviewed the proposed rule change and finds that it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁸ which requires, among other things, that

⁶ This modified participation entitlement overlay would only be applicable to automatic executions and would not be applicable for executions of incoming electronic orders initiated from PAR or from electronic auctions. Instead, the original participation entitlement parameters would be applied for PAR and electronic auctions. In pro-rata classes where the UMA method is selected to calculate the Market-Maker's modified participation entitlement share, executions of incoming electronic orders initiated from PAR and electronic auctions would be allocated using the UMA method. Therefore, in such classes, the Market-Maker's original participation entitlement share of a PAR or electronic auction execution would be calculated using the UMA method.

⁷ 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).

⁸ 15 U.S.C. 78f(b)(5).

the rules of an exchange be designed to promote just and equitable principles of trade, 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; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers; as well as Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or in furtherance of the Act.⁹

The Commission believes that the proposed rule change amending the market turner and modified participation entitlement overlays is consistent with the Act. All public customer orders at the best price will continue to be satisfied before a participation entitlement will be applied. If an entitlement is not applied, then the incoming order will be allocated among all market participants using the underlying matching algorithm—price-time or pro-rata—both of which the Commission already has found consistent with the Act.¹⁰ In addition, the Exchange's overlay determinations will be distributed via regulatory circular. For these reasons, the Commission believes that the proposed rule change is consistent with the Act.

⁹ 15 U.S.C. 78f(b)(8).

¹⁰ See Securities Exchange Act Release No. 51822 (June 10, 2005), 70 FR 35321 (June 17, 2005) (Adopting CBOE Rule 6.45B).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹¹ that the proposed rule change (SR-CBOE-2010-038), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹²

Florence E. Harmon
Deputy Secretary

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).