

July 9, 2013

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, to Amend Rule 6.53(u), Relating to Qualified Contingent Cross Orders

I. Introduction

On March 28, 2013, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) 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 amend CBOE Rule 6.53(u) to allow Qualified Contingent Cross (“QCC”) Orders with more than one option leg to be entered in \$0.01 increments. The proposed rule change was published for comment in the Federal Register on April 16, 2013.³ CBOE filed Amendment No. 1 to the proposal on April 18, 2013.⁴ CBOE filed Amendment No. 2 to the proposal on May 29, 2013.⁵ On June 5, 2013, the Commission published notice of and solicited

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 69360 (April 10, 2013), 78 FR 22591.

⁴ In Amendment No. 1, CBOE added an additional paragraph at the end of the purpose section stating that: (1) a QCC Order with multiple legs is a form of a complex order and should be able to be entered in \$0.01 increments, as non-QCC complex orders can currently be entered in \$0.01 increments; and (2) such orders still cannot trade unless they are at or between the NBBO and the opportunity to trade QCC Orders with multiple legs in \$0.01 increments provides an opportunity for price improvement at this smaller increment level. The paragraph added in Amendment No. 1 was deleted and replaced by language added in Amendment No. 2. See note 5 infra.

⁵ In Amendment No. 2, CBOE replaced the paragraph added by Amendment No. 1 with two paragraphs at the end of the purpose section stating that: (1) were it not for language in CBOE Rule 6.53(u) that limits the entry of QCC Orders to the standard increments applicable to simple orders in the options class of each leg, QCC Orders with multiple legs would be allowed to be traded in \$0.01 increments under CBOE Rule 6.42; (2) the nature of the pricing of a complex order, whether a QCC Order or otherwise, is such that

comment on the proposed rule change, as modified by Amendment Nos. 1 and 2, and extended the time period for Commission action on the proposal to July 15, 2013.⁶ The Commission received no comments regarding the proposal, as amended. This order approves the proposed rule change, as modified by Amendment Nos. 1 and 2.

II. Description of the Proposal

Currently, CBOE Rule 6.53(u) states that QCC Orders may only be entered in the standard increments applicable to simple orders in the options class under CBOE Rule 6.42.⁷

the pricing is based on the relative price of one option versus another and thus the standard increment of trading of a complex order's individual options legs is less relevant to the pricing of the complex order; (3) the proposed amendment to permit QCC Orders with more than one option leg to be entered in the increments specified for complex orders under CBOE Rule 6.42 (i.e., \$0.01 increments) would put the trading of QCC Orders with multiple legs on the same footing as the trading of other types of complex orders; (4) pursuant to CBOE Rule 6.53(u)(ii), each options leg of a complex QCC Order cannot trade unless each leg provides price improvement over a public customer order resting in the electronic book and is at or between the NBBO, and to date, CBOE has never had to reject a submitted complex QCC Order because it would have violated either of these principles; and (5) permitting the trading of QCC Orders with multiple legs in \$0.01 increments would provide an opportunity for price improvement at this smaller increment level.

⁶ See Securities Exchange Act Release No. 69675 (May 30, 2013), 78 FR 33868.

⁷ A QCC Order is an order to buy (or sell) at least 1,000 standard option contracts or 10,000 mini-option contracts that is identified as being part of a qualified contingent trade coupled with a contra-side order to sell (or buy) an equal number of contracts. A "qualified contingent trade," or "QCT," is a transaction consisting of two or more component orders, executed as agent or principal, where: (1) at least one component is an NMS stock, as defined in Rule 600 of Regulation NMS under the Act; (2) all components are effected with a product or price contingency that either has been agreed to by all the respective counterparties or arranged for by a broker-dealer as principal or agent; (3) the execution of one component is contingent upon the execution of all other components at or near the same time; (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined by the time the contingent order is placed; (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or cancelled; and (6) the transaction is fully hedged (without regard to any prior existing position) as a result of other components of the contingent trade. See CBOE Rule 6.53(u)(i). The six requirements are substantively identical to the six

CBOE Rule 6.42 provides trading increments of \$0.01, \$0.05, or \$0.10 for individual option series, and orders to buy or sell a single option series must be entered in the trading increment applicable to the series. CBOE Rule 6.42(4) allows bids and offers on complex orders to be expressed in any increment, regardless of the minimum increment otherwise applicable to the individual legs of the complex order. CBOE proposes to amend CBOE Rule 6.53(u) to permit QCC orders with more than one option leg to be entered in the increments specified for complex orders under CBOE Rule 6.42, i.e., \$0.01 increments.⁸

CBOE believes that, because a QCC Order with multiple option legs is a form of complex order, these QCC Orders also should be permitted to be entered in \$0.01 increments, a change the Exchange states would place QCC Orders with multiple options legs on the same footing as other types of complex orders.⁹ CBOE states that the pricing of a complex order, whether or not it is a QCC Order, is based on the relative price of one option leg to another (as opposed to the outright price of a single option), and therefore that the standard increment of trading of the individual legs of a complex order is less relevant to the pricing of the complex order.¹⁰ In addition, CBOE notes that, under CBOE Rule 6.53(u)(ii), each option leg of a complex QCC Order must: (1) provide price improvement over a public customer order resting in the electronic book; and (2) be at or between the NBBO.¹¹ CBOE also states that it has never

elements of a QCT under the Commission's QCT exemption. See Securities Exchange Act Release Nos. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) ("Original QCT Exemption") and 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) ("CBOE QCT Exemption"). The current QCT exemption (i.e., as modified by the CBOE QCT Exemption) is referred to herein as the "NMS QCT Exemption."

⁸ QCC Orders with one option leg would continue to trade in the standard increment applicable to simple orders in the option class. See CBOE Rule 6.53(u).

⁹ See Amendment No. 2.

¹⁰ See id.

¹¹ See id.

had to reject a complex QCC Order because it would have violated either of these principles.¹² Finally, CBOE believes that allowing QCC Orders with multiple options legs to be entered in \$0.01 increments will provide an opportunity for price improvement at a smaller increment level.¹³

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, with Section 6(b) of the Act.¹⁴ In particular, the Commission finds that the proposed rule change is consistent with Sections 6(b)(5)¹⁵ and 6(b)(8),¹⁶ which require, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, 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 that the rules of an exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In addition, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,¹⁷ in which Congress found that it is in the public interest and appropriate for the protection

¹² See id.

¹³ See id.

¹⁴ 15 U.S.C. 78f(b). 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).

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 15 U.S.C. 78f(b)(8).

¹⁷ 15 U.S.C. 78k-1(a)(1)(C).

of investors and the maintenance of fair and orderly markets to assure, among other things, the economically efficient execution of securities transactions.

In 2011, the Commission approved CBOE's proposal to establish rules providing for the trading of QCC Orders on CBOE,¹⁸ which followed the Commission's approval of a proposal by the International Stock Exchange, LLC ("ISE") to trade QCC Orders.¹⁹ In the ISE Order, the Commission noted that the parties to a contingent trade are focused on the spread or ratio between the transaction prices for each of the component instruments (i.e., the net price of the entire contingent trade), rather than the absolute price of any single component.²⁰ Under the requirements of the NMS QCT Exemption, the spread or ratio between the relevant instruments must be determined at the time the order is placed, and this spread or ratio stands regardless of the market prices of the individual orders at their time of execution.²¹ As the Commission noted in the Original QCT Exemption, "the difficulty of maintaining a hedge, and the risk of falling out of hedge, could dissuade participants from engaging in contingent trades, or at least raise the cost of such trades."²² Thus, the Commission found that, if each stock leg of a qualified contingent trade were required to meet the trade-through provisions of Rule 611 of Regulation NMS, such trades could become too risk and costly to be employed successfully and noted that the

¹⁸ See Securities Exchange Act Release No. 64653 (June 13, 2011), 76 FR 35491 (June 17, 2011) (order approving CBOE-2011-041) ("CBOE QCC Approval Order").

¹⁹ See Securities Exchange Act Release No. 63955 (February 24, 2011), 76 FR 11533 (March 2, 2011) (order approving ISE-2010-73) ("ISE Order").

²⁰ See ISE Order at 11540.

²¹ See id. See also supra note 7.

²² See Original QCT Exemption at 52831.

elimination or reduction of this trading strategy potentially could remove liquidity from the market.²³

CBOE's QCC Orders allow a Trading Permit Holder to cross the options leg(s) of a qualified contingent trade in a Regulation NMS stock on CBOE immediately, without exposure, provided that the requirements of CBOE Rule 6.53(u) are satisfied. In approving CBOE's proposal, the Commission stated that QCC Orders could facilitate the execution of qualified contingent trades, which the Commission previously had found to be beneficial to the market as a whole by contributing to the efficient functioning of the securities markets and the price discovery process.²⁴ The Commission noted that QCC Orders would provide assurance to parties to stock-option qualified contingent trades that their hedge would be maintained by allowing the options component of the qualified contingent trade to be executed as a clean cross.²⁵

The CBOE QCC Approval Order stated further that, although the Commission believed that order exposure is generally beneficial to the options markets in that it provides an incentive to options market makers to provide liquidity and therefore plays an important role in ensuring competition and price discovery in the options markets, the Commission also has recognized that contingent trades can be "useful trading tools for investors and other market participants, particularly those who trade the securities of issuers involved in mergers, different classes of shares of the same issuers, convertible securities, and equity derivatives such as options [italics added],"²⁶ and that "[t]hose who engage in contingent trades can benefit the market as a whole

²³ See id.

²⁴ See CBOE QCC Approval Order at 35492, citing Original QCT Exemption, supra note 7.

²⁵ See CBOE QCC Approval Order at 35492.

²⁶ See CBOE QCC Approval Order at 35492, citing Original QCT Exemption at 52830-31.

by studying the relationships between prices of such securities and executing contingent trades when they believe such relationships are out of line with what they believe to be fair value.”²⁷ Thus, the Commission believed that transactions that meet the specified requirements of the NMS QCT Exemption could be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.²⁸

In the CBOE QCC Approval Order, the Commission stated that the benefits provided by the exposure requirement and by qualified contingent trades, such as QCC Orders, required the Commission to weigh the relative merits of both for the options markets.²⁹ The Commission found that CBOE’s rule, by requiring a QCC Order to be: (1) part of a qualified contingent trade under Regulation NMS; (2) for at least 1,000 contracts; (3) executed at a price at or between the NBBO; and (4) cancelled if there is a public customer order on the electronic book, struck an appropriate balance for the options markets in that it was narrowly drawn and established a limited exception to the general principle of exposure and retained the general principle of customer priority in the options markets.³⁰ The Commission noted, further, that the requirement that a QCC Order be part of a qualified contingent trade that satisfies each of the six underlying requirements of the NMS QCT Exemption, and the requirement that a QCC Order be for a minimum size of 1,000 contracts, further limited the use of QCC Orders by ensuring that only transactions of significant size would be able to avail themselves of the order type.³¹

²⁷ See id.

²⁸ See CBOE QCC Approval Order at 35492, citing CBOE QCT Exemption at 19273.

²⁹ See CBOE QCC Approval Order at 35492.

³⁰ See id.

³¹ See CBOE QCC Approval Order at 35492-93. The CBOE QCC Approval Order also noted CBOE’s representation that, to effect proprietary orders (including QCC Orders) electronically from on the floor of the Exchange, members must qualify for an exemption from Section 11(a)(1) of the Act, 15 U.S.C. 78k(a)(1), which concerns proprietary trading

The Commission believes that the analysis in the CBOE QCC Approval Order applies equally to the current proposal. By allowing QCC Orders with more than one option leg to trade in \$0.01 increments, rather than in the standard increment applicable to single leg orders in the options class, the proposal could facilitate the execution of QCC Orders with multiple option legs by providing additional price points at which these orders would be able to be executed, which, in turn, could facilitate the execution of qualified contingent trades. As discussed above, the Commission previously has found that transactions that meet the specified requirements of the NMS QCT Exemption could benefit the market as a whole by contributing to the efficient functioning of the securities markets and the price discovery process. Further, as discussed above, QCC Orders provide assurance to the parties to a stock-option qualified contingent trade that their hedge will be maintained by allowing the options component of the order to be executed as a clean cross. By allowing QCC Orders with multiple option legs to be executed in \$0.01 increments, the proposal could further facilitate the execution of the option component of a stock-option qualified contingent trade.

The Commission notes that CBOE Rule 6.53(u) will continue to require that QCC Orders, including those with multiple option legs, be: (1) part of a qualified contingent trade under Regulation NMS; (2) for at least 1,000 standard option contracts;³² (3) executed at a price at or between the NBBO; and (4) cancelled if there is a public customer order at the same price

on an exchange by an exchange member. Among other things and as discussed in greater detail in the CBOE QCC Approval Order, CBOE recognized that Trading Permit Holders effecting QCC Orders and relying on the “G” exemption for yielding priority to non-members under Section 11(a)(1)(G) of the Act and Rule 11a1-1(T) thereunder would be required to yield priority to any interest, not just public customer orders, in the electronic book at the same price to ensure that non-member interest is protected. See CBOE QCC Approval Order at 35493.

³² For mini-option contracts, the minimum size is 10,000 contracts. See CBOE Rule 6.53(u).

resting on the electronic book. Thus, the Commission believes that the proposal continues to strike an appropriate balance for the options market in that it is narrowly drawn and in that it establishes a limited exception to the general principle of exposure and retains the general principle of customer priority in the options markets.³³

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with Section 6(b)(5)³⁴ and 6(b)(8)³⁵ of the Act. Further, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act.³⁶

³³ See CBOE QCC Approval Order at 35492.

³⁴ 15 U.S.C. 78f(b)(5).

³⁵ 15 U.S.C. 78f(b)(8).

³⁶ 15 U.S.C. 78k-1(a)(1)(C).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁷ that the proposed rule change (SR-CBOE-2013-041), as modified by Amendment Nos. 1 and 2, is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁸

Kevin M. O'Neill
Deputy Secretary

³⁷ 15 U.S.C. 78s(b)(2).

³⁸ 17 CFR 200.30-3(a)(12).