

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-72329; File No. SR-CBOE-2014-017)

June 5, 2014

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment 1, to Amend Its Rules Related to Complex Orders

I. Introduction

On February 19, 2014, Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its rules relating to complex orders. On March 3, 2014, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1 thereto, was published for comment in the Federal Register on March 10, 2014.<sup>3</sup> The Commission received no comments on the proposed rule change. On April 23, 2014, the Commission extended the time period in which to either approve the proposal, disapprove the proposal, or to institute proceedings to determine whether to approve or disapprove the proposal, to June 6, 2014.<sup>4</sup> This order institutes proceedings under Section 19(b)(2)(B) of the Act<sup>5</sup> to determine whether to approve or disapprove the proposal.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 71648 (March 5, 2014), 79 FR 13359 (“Notice”).

<sup>4</sup> See Securities Exchange Act Release No. 72008, 79 FR 24032 (April 29, 2014).

<sup>5</sup> 15 U.S.C. 78s(b)(2)(B).

## II. Description of Proposed Rule Change

Under current CBOE Rule 6.53C(d)(ii), a Trading Permit Holder representing a COA-eligible order may request that the Exchange initiate a complex order auction (“COA”) for the COA-eligible order before such order enters the complex order book (“COB”).<sup>6</sup> In this proposed rule change, the Exchange proposes to require all complex orders with three or more legs to be subject to a COA prior to entering the COB.<sup>7</sup> Specifically, the Exchange proposes to amend Rule 6.53C(d)(ii) to provide that CBOE’s Hybrid Trading System<sup>8</sup> (the “System”) will initiate a COA on receipt of: (1) a COA-eligible order with two legs and request from the Trading Permit Holder representing the order that it initiate a COA; or (2) a complex order with three or more legs, regardless of the order’s routing parameters (e.g., a request to route directly to the COB) or handling instructions (except for orders routed for manual handling).<sup>9</sup> Thus, as proposed, all complex orders in Hybrid classes with three or more legs would automatically be subject to a COA (other than those routed for manual handling) prior to entering the COB where they can leg into the market.<sup>10</sup>

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<sup>6</sup> Under current CBOE Rule 6.53C(d)(i)(2), the Exchange may determine on a class-by-class basis which complex orders are eligible for a COA, including by complex order type and origin type. The Exchange notes that currently, in all Hybrid classes, customer, firm and broker-dealer complex orders are eligible for a COA, and all complex order types except for immediate-or-cancel (“IOC”) orders are eligible for a COA in all Hybrid classes. See Notice, supra note 3, n.8. Additionally, only marketable orders and “tweeners” (limit orders bettering the same side of the derived net market) are eligible for a COA. For Hybrid 3.0 classes (i.e. SPX), all complex order types (including IOC orders) are eligible for a COA, but only customer complex orders are eligible for a COA. See id. (citing CBOE Regulatory Circulars RG06-73, RG08-38, and RG08-97).

<sup>7</sup> The Exchange explains that this proposed change applies to Hybrid classes only, and not Hybrid 3.0 classes. See Notice, supra note 3, n.7. In this regard, the proposed rule change proposes to amend CBOE Rule 6.53C, Interpretation and Policy .10 to indicate that complex orders in Hybrid 3.0 classes, regardless of the number of legs, will initiate a COA in the same manner they currently do. See id.

<sup>8</sup> The proposed rule change proposes to amend CBOE Rule 6.53C(d)(ii) to say that the System, rather than the Exchange, will send the RFR message. See id. at n.9. Because

The Exchange proposes to amend CBOE Rule 6.53C(d)(ii) to provide that CBOE's System will reject back to a Trading Permit Holder any complex order with three or more legs that includes a request pursuant to CBOE Rule 6.53C, Interpretation and Policy .04<sup>11</sup> that the order not initiate a COA.<sup>12</sup> The Exchange also proposes to amend CBOE Rule 6.53C(d)(ii), which currently provides that only a Trading Permit Holder representing an order may request that the order initiate a COA, to also provide that PAR operators handling an order may request that a COA-eligible order initiate a COA.<sup>13</sup>

According to the Exchange, this proposed rule change will address the concern that market makers may reduce the size of their quotations in the leg markets because of the presence of certain complex orders that are designed to circumvent the "Quote Risk Monitor Mechanism"

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the System will automatically send the RFR message when the conditions set forth in CBOE Rule 6.53C(d)(ii) are met, the Exchange believes using the term "System" in the rule text is appropriate. See id.

<sup>9</sup> The Exchange explains that if a complex order with three or more legs contains an instruction to route for manual handling, such as to PAR, and through such manual handling routes to the COB, the proposed rule change would provide that such order will initiate a COA prior to entry on the COB, even if the PAR operator requests that the order not initiate a COA. See Notice, supra note 3, n.10.

<sup>10</sup> The Exchange states that this automatic initiation of a COA does not apply to stock-option orders. See id. at n.11.

<sup>11</sup> CBOE Rule 6.53C, Interpretation and Policy .04 provides that Trading Permit Holders routing complex orders directly to the COB may request that the complex orders initiate a COA on a class-by-class basis and Trading Permit Holders with resting complex orders on PAR may request that complex orders initiate a COA on an order-by-order basis.

<sup>12</sup> See Notice, supra note 3, at 13362.

<sup>13</sup> CBOE believes that permitting orders resting on PAR to initiate a COA is consistent with other CBOE rules. See id. at n. 15 and accompanying text (citing to CBOE Rule 6.53C(d), which, according to the Exchange, states that complex orders may be subject to a COA once on PAR, and CBOE Rule 6.53C, Interpretation and Policy .04(a), which, according to the Exchange, states that Trading Permit Holders with resting complex orders on PAR may request that complex orders initiate a COA).

("QRM") settings established by market makers.<sup>14</sup> CBOE describes the QRM as a functionality designed to help market makers provide liquidity across most series in their appointed classes without being at risk of executing the full cumulative size of all their quotes before being given adequate opportunity to adjust their quotes.<sup>15</sup>

The QRM, according to CBOE, generally operates by allowing market makers to set a variety of parameters, which, if triggered, will cause the System to cancel a market maker's quotes in all series in an appointed class after executing the order that triggered the parameter.<sup>16</sup> CBOE states that the System performs the QRM parameter calculations to determine if the QRM has been triggered after each execution against a market maker's quotes.<sup>17</sup> According to the Exchange, when a complex order legs into the regular market (*i.e.*, executes against individual quotes for each of the legs in the regular market), all of the legs of a complex order are considered as a single execution for purposes of the QRM, and not as a series of individual transactions, because each leg of the complex order is contingent on the other leg.<sup>18</sup> Thus, the System performs the QRM parameter calculations after the entire complex order executes against interest in the regular market. In contrast, if the legs of the complex order had been submitted to the regular market separately and without any complex order contingency, the System would perform the QRM parameter calculations after each leg executed against interest in the regular market. According to the Exchange, this differential treatment may result in market makers

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<sup>14</sup> See Notice, *supra* note 3, at 13363.

<sup>15</sup> See *id.* at 13361.

<sup>16</sup> See *id.* at 13360-61. CBOE states that the System performs the parameter calculations after an execution against a market maker quote occurs in order to assure that all quotations are firm for their full size. See *id.* at 13361.

<sup>17</sup> See *id.*

<sup>18</sup> See *id.*

exceeding their risk parameters by a greater number of contracts when complex orders leg into the regular market.<sup>19</sup>

The Exchange believes that the potential risk to market makers of complex orders legging into the regular market limits the amount of liquidity that market makers are willing to provide in the regular market.<sup>20</sup> In particular, according to the Exchange, market makers may reduce the size of their quotations in the regular market because of the presence of these complex orders that are designed to circumvent QRM and risk the execution of the cumulative size of market makers' quotations across multiple series without market makers' being aware of these complex orders or having an opportunity to adjust their quotes.<sup>21</sup> Accordingly, the Exchange believes that reducing market maker risk in the regular market by requiring complex orders in Hybrid classes with three or more legs to be subject to a COA—which will allow market makers to react accordingly, including adjusting their quotes to avoid the circumvention of their QRM parameter settings—will benefit investors by encouraging market makers to provide additional liquidity in the regular market and enhance competition in those classes.<sup>22</sup> According to the Exchange, this potential benefit to investors far exceeds any “perceived detriment” to requiring certain complex orders to be subject to a COA prior to potential interaction with the leg markets.<sup>23</sup> The Exchange notes that complex orders with three or more legs will still have opportunities for execution through a COA, in the COB or in the leg markets if they do not execute at the end of the COA.<sup>24</sup>

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<sup>19</sup> See id.

<sup>20</sup> See Notice, supra note 3, at 13362.

<sup>21</sup> See id.

<sup>22</sup> See id.

<sup>23</sup> See id.

<sup>24</sup> See id.

In the Notice, the Exchange states that it will announce the implementation date of the proposed rule change in a Regulatory Circular to be published no later than 90 days following the effective date of this proposed rule change.<sup>25</sup> The Exchange also states that the implementation date will be no later than 180 days following the effective date of this proposed rule change.<sup>26</sup>

III. Proceedings to Determine Whether to Approve or Disapprove SR-CBOE-2014-017 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>27</sup> to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change, as discussed below. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act,<sup>28</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of, and input from commenters with respect to, the proposed rule change's consistency with Section 6(b)(5) of the Act, which require that the rules of a national securities exchange be designed, among other things, to prevent fraudulent and manipulative acts

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<sup>25</sup> See Notice, supra note 3, at 13363.

<sup>26</sup> See id.

<sup>27</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>28</sup> Id. Section 19(b)(2)(B) of the Exchange Act also provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. See id. The time for conclusion of the proceedings may be extended for up to 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding. See id.

and practices, 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; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>29</sup>

#### IV. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the concerns identified above, as well as any other concerns they may have with the proposed rule change. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5)<sup>30</sup> or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>31</sup>

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule change should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. The Commission asks that commenters address the sufficiency and merit of the

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<sup>29</sup> 15 U.S.C. 78f(b)(5).

<sup>30</sup> Id.

<sup>31</sup> Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Repts. No. 75, 94th Cong., 1st Sess. 30 (1975).

Exchange's statements in support of the proposed rule change, in addition to any other comments they may wish to submit about the proposed rule change. In particular, the Commission seeks comment on the following:

1. According to the Exchange, the proposed rule change is designed to limit a market maker's risk against executions of complex orders with three or more legs. Please provide data, if available, showing how the execution of such orders against market maker quotes in the regular market affects a market maker's risk exposure, including for complex orders with only three legs.

2. Do commenters agree with CBOE's assertion that the potential risk to market makers in the regular market that may result from complex orders with three or more legs legging into the regular market outweighs the potential benefit of continuing to allow a COA to remain voluntary for complex orders with three or more legs? If so, why? If not, why not?

3. Do commenters agree with CBOE's assertion that the proposed rule change would encourage market makers to provide additional liquidity on the Exchange? If so, why? If not, why not? To the extent possible, please provide supporting data.

4. Do commenters agree with CBOE's assertion that any resulting benefit to investors far exceeds any "perceived detriment" of requiring certain complex orders to be subject to a COA prior to potential interaction with the leg markets? If so, why? If not, why not? What are the possible "perceived detriment[s]" that could result from the proposal?

5. The proposed rule change would require that complex orders of three or more legs be subject to a COA prior to potential interaction with the leg markets. What are commenters' views on the impact of such a requirement on the execution of such complex orders? Please explain.



6. Do commenters agree with CBOE's assertion that market makers may reduce the size of their quotations if complex orders of three or more legs are able to execute against the leg markets? Have market makers already begun to reduce the size of their quotations as a result of such orders? If so, when did market makers begin reducing the size of their quotes? Was there a particular event or other change that resulted in additional executions against the leg markets that, in turn, prompted market makers to begin changing the size of their quotes? To the extent possible, please provide supporting data.

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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2014-017 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2014-017. 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 website (<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 website viewing and printing 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 such filings also will be available for inspection and copying at the principal office of the Exchange. 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-2014-017 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>32</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>32</sup> 17 CFR 200.30-3(a)(57).