

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51271; File No. SR-CBOE-2004-45)

February 28, 2005

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 2 and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 5 by the Chicago Board Options Exchange, Inc. Relating to the Trading of Complex Orders on the CBOE Hybrid System

I. Introduction

On July 16, 2004, the Chicago Board Options, Inc. ("CBOE") filed with the Securities and Exchange Commission ("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 create a complex order book ("COB") for certain complex orders traded on the CBOE Hybrid System ("Hybrid"). On November 8, 2004, the CBOE filed and withdrew Amendment No. 1 to the proposal and filed Amendment No. 2 to the proposal.<sup>3</sup> The CBOE filed Amendment No. 3 to the proposal on January 31, 2005.<sup>4</sup> The CBOE filed Amendment No. 4 to the proposal on February 4, 2005, and withdrew Amendment No. 4 on February 10, 2005. The CBOE filed Amendment No. 5 to the proposal on February 11, 2005.<sup>5</sup>

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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> Amendment No. 2 supersedes and replaces the original filing in its entirety.

<sup>4</sup> Amendment No. 3 revises the proposal to add Interpretation and Policy .01 to CBOE Rule 6.53C. Interpretation and Policy .01 states that conversions and reversals are not eligible for routing to the COB, and that the CBOE will file any changes to Interpretation and Policy .01 with the Commission pursuant to Section 19(b)(3)(A) of the Act.

<sup>5</sup> Amendment No. 5 adds Interpretation and Policy .02 to CBOE Rule 6.53C. Interpretation and Policy .02 states that until May 27, 2005, the N-second group timer, as described in CBOE Rule 6.45A(c), for complex order transactions will be set at zero seconds. Effective May 30, 2005, the N-second timer for complex order transactions will be set at the same length for complex order transactions and for transactions that do not involve complex orders.

The proposed rule change and Amendment No. 2 were published for comment in the Federal Register on November 23, 2004.<sup>6</sup> The Commission received one comment letter regarding the proposal.<sup>7</sup> The CBOE responded to the comment letter on January 13, 2005.<sup>8</sup> This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments on and is simultaneously approving, on an accelerated basis, Amendment Nos. 3 and 5.

## II. Description of the Proposed Rule Change

Complex options orders involve multiple options transactions that are executed simultaneously as part of a single strategy. The CBOE currently routes complex orders to the PAR terminal in an options trading crowd. A complex order resides on PAR until the Designated Primary Market Maker ("DPM") announces the order to the trading crowd and the order trades in open outcry. Thus, under the CBOE's current rules, a DPM must intervene to execute complex orders. To facilitate more automated handling of complex orders, the CBOE proposes to adopt CBOE Rule 6.53C, "Complex Orders on the Hybrid System," which establishes a COB for certain complex orders traded on Hybrid.<sup>9</sup>

The appropriate CBOE committee will decide, on a class by class basis, whether complex

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<sup>6</sup> See Securities Exchange Act Release No. 50682 (November 17, 2004), 69 FR 61897.

<sup>7</sup> See letter from Matthew Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, LLC, to Jonathan G. Katz, Secretary, Commission, dated December 15, 2004 ("Citadel Letter").

<sup>8</sup> See letter from Stephen M. Youhn, Managing Senior Attorney, CBOE, to Jonathan G. Katz, Secretary, Commission, dated January 13, 2005 ("CBOE Letter").

<sup>9</sup> Complex orders in non-Hybrid classes will not be placed in the COB. The following types of complex orders, as defined in CBOE Rule 6.53C(a), will be eligible for routing to the COB: spread orders; straddle orders; strangle orders; combination orders; ratio orders; butterfly spread orders; box/roll spread orders; and collar orders and risk reversals. Only complex orders with no more than four legs are eligible for the COB. See CBOE Rule 6.53C(c)(iv). Conversions and reversals will not be eligible for routing to the COB. See Amendment No. 3, supra note 4.

orders in an options class will route directly to the COB or to PAR.<sup>10</sup> In addition, the appropriate CBOE committee will decide whether to allow complex orders from non-broker-dealer public customers and from broker-dealers that are not options exchange market makers or specialists to route from PAR to the COB.<sup>11</sup> The CBOE will announce routing decisions to members via Regulatory Circular.<sup>12</sup>

When a complex order routes to PAR, the DPM will announce the order to the trading crowd, which may trade with the order at its limit price or offer price improvement. If the trading crowd chooses not to trade with the order, the order will reside on PAR until the DPM routes the order to the COB.

An order routed to the COB may trade in one of three ways. First, the order may execute automatically against individual orders or quotes in the CBOE's electronic book ("EBook"), provided that the complex order can be executed in full, or in a permissible ratio, by orders in EBook. Second, an incoming complex order that is marketable against a complex order resting in the COB may execute automatically against the resting order. Third, market participants, as defined in CBOE Rule 6.45A, "Priority and Allocation of Trades for CBOE Hybrid System," may trade against orders in the COB.<sup>13</sup> CBOE members with an interface connection to the CBOE will be able to view orders resting in the COB.

A complex order in the COB will be allocated to market participants in accordance with

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<sup>10</sup> See CBOE Rule 6.53C(c)(i).

<sup>11</sup> See CBOE Rule 6.53C(c)(i).

<sup>12</sup> See CBOE Rule 6.53C(c)(i).

<sup>13</sup> CBOE Rule 6.45A defines "market participant," for purposes of that rule, to include an in-crowd market maker, a market maker complying with the in-person requirements of CBOE Rule 8.7.03(B)(1) who submits quotes from off the CBOE floor through the facilities of the CBOE, an in-crowd DPM, an e-DPM, and a floor broker representing orders in the trading crowd.

the allocation procedures described in CBOE Rule 6.45A(c). In addition, CBOE Rule 6.45A, Interpretation and Policies .01 and .02, apply to complex orders on Hybrid.<sup>14</sup>

Complex orders resting in the COB may be executed without consideration to the prices of the same complex orders that might be available on other exchanges.<sup>15</sup> Orders of public customers in the COB will have priority over orders from non-public customers, and multiple public customer complex orders at the same price will be accorded priority based on time.<sup>16</sup>

CBOE Rules 6.45, "Priority of Bids and Offers," and 6.45A(b)(iii) generally allow a member holding a complex order to trade ahead of the book on one leg of the order, provided that the other leg of the order betters the corresponding bid (offer) in the limit order book. These rules will continue to apply to the trading of complex orders.

Amendment No. 3 adopts Interpretation and Policy .01 to CBOE Rule 6.53C. Interpretation and Policy .01 states that conversions and reversals will not be eligible for routing to the COB and that the CBOE will file any changes to Interpretation and Policy .01 with the Commission pursuant to Section 19(b)(3)(A) of the Act.

Amendment No. 5 adopts Interpretation and Policy .02 to CBOE Rule 6.53C.

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<sup>14</sup> CBOE Rule 6.45A, Interpretation and Policy .01, "Principal Transactions," prohibits an order entry firm from executing as principal against an order it represent as agent unless: (1) the agency order is first exposed on Hybrid for at least 30 seconds; (2) the order entry firm has been bidding or offering for at least 30 seconds prior to receiving an agency order that is executable against such bid or offer; or (3) the order entry firm proceeds in accordance with the crossing rules in CBOE Rule 6.74, "'Crossing' Orders." CBOE Rule 6.45A, Interpretation and Policy .02, "Solicitation Orders," requires an order entry firm to expose for at least 30 seconds an order it represents as agent before the order may be executed electronically via the electronic execution mechanism of Hybrid, in whole or in part, against orders solicited from members and non-member broker-dealers to transact with the order.

<sup>15</sup> See CBOE Rule 6.53C(c)(iii). The Options Price Reporting Authority does not disseminate complex order prices. This provision of the CBOE's proposal is similar to International Securities Exchange Rule 722(b)(3).

<sup>16</sup> See CBOE Rule 6.53C(c)(ii).

Interpretation and Policy .02 states that until May 27, 2005, the N-second group timer, as described in CBOE Rule 6.45A(c), for complex order transactions will be set at zero seconds.<sup>17</sup> Effective May 30, 2005, the N-second timer for complex order transactions will be set at the same length for complex order transactions and for transactions that do not involve complex orders. According to the CBOE, the systems changes required to extend the N-second timer to the COB will not be ready until May. Interpretation and Policy .02 affects only the length of the N-second timer and has no impact on customer orders.

### III. Summary of Comments Received and CBOE Response

The Commission received one comment letter regarding the proposal.<sup>18</sup> Although the commenter believed that the COB would increase transparency, the commenter expressed concern that the proposal would allow a CBOE committee, rather than DPMs and order routers, to determine the options classes that would be eligible for routing to the COB. The commenter believed that DPMs and order routers should have the ability to decide where complex orders would be routed. In this regard, the commenter stated that a DPM would have first-hand knowledge and experience with respect to the level of trading activity in his or her crowd and would know when it would be beneficial to route orders directly for automatic execution. The commenter also believed that order routers should be able to choose whether to route orders directly to the COB or to have their orders represented manually in the trading crowd.

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<sup>17</sup> CBOE Rule 6.45A(c)(ii) states that each market participant that submits an order or quote to buy (sell) an order in the electronic book within a period of time not to exceed five seconds of the first market participant to submit an order ("N-second group") will be entitled to receive an allocation of the order in the electronic book pursuant to the allocation algorithm specified in CBOE Rule 6.45A(c)(ii). The appropriate Floor Procedure Committee ("FPC") determines the length of the N-second group timer, provided, however, that the duration of the N-second group timer may not exceed five seconds. See CBOE Rule 6.45A(c)(ii)(A).

<sup>18</sup> See Citadel Letter, supra note 7.

In its response, the CBOE states that CBOE committees historically have had the responsibility, by CBOE rule and by charter, to determine the routing of orders. The CBOE notes that CBOE Rules 6.8, "RAES Operations," and 6.13, "CBOE Hybrid System's Automatic Execution Feature," provide CBOE committees with the authority to determine whether to allow orders from certain market professionals to auto-ex or to route to PAR.<sup>19</sup> Similarly, the CBOE notes that CBOE Rule 7.4, "Obligations for Orders," allows CBOE committees to determine whether orders from certain market professionals should be eligible for routing into the electronic order book. According to the CBOE, the committees, which represent a broad cross-section of CBOE members, including market makers, DPMs, and order flow providers, consider multiple factors in making order routing decisions. The CBOE believes that providing DPMs and order routers with the unilateral ability to make order routing decisions would undermine the committee process and prevent the development of uniform order routing policies.

In addition, CBOE notes that its committees have yet to make any routing determinations for complex orders. CBOE states that such determinations would be evaluated on an ongoing basis and would take into account competitive forces and customer requests.

#### IV. Discussion

The Commission has carefully reviewed the proposed rule change, the comment letter, and the CBOE's response and finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>20</sup> In particular, the Commission finds that the proposed rule change, as

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<sup>19</sup> See CBOE Letter, *supra* note 8.

<sup>20</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

amended, is consistent with Section 6(b)(5) of the Act,<sup>21</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.

A complex order sent to the CBOE currently routes to the PAR terminal in a trading crowd, where the DPM announces the order to the trading crowd. If the trading crowd does not trade immediately with the order, the order will reside on PAR until it trades in open outcry. Thus, a complex order currently cannot be executed on the CBOE without manual intervention by a DPM.

The COB will allow complex orders to trade electronically, without the intervention of a DPM, and orders on the COB will be displayed to all CBOE members with an interface connection to the CBOE. As described more fully above, a complex order routed to the COB may execute automatically against orders in the EBook or against an order resting in the COB. In addition, market participants, as defined in CBOE Rule 6.45A, may trade against orders resting in the COB. Accordingly, the Commission believes that the COB should increase the transparency of complex orders and could facilitate the execution of complex orders.

Under the proposal, the appropriate CBOE committee will decide, on a class by class basis, the options classes that will route directly to the COB and those that will route to PAR.<sup>22</sup> As noted above, CBOE committees currently make some order routing determinations under

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<sup>21</sup> 15 U.S.C. 78f(b)(5).

<sup>22</sup> The appropriate CBOE committee also will determine whether to allow complex orders from non-broker-dealer customers and from broker-dealers that are not options exchange market makers or specialists to route from PAR to the COB. See CBOE Rule 6.53C(c)(i).

existing CBOE rules.<sup>23</sup> Accordingly, the Commission believes that the discretion granted to CBOE committees with respect to the routing of complex orders under the proposal is consistent with the authority granted to CBOE committees under the CBOE's existing rules.

The Commission notes that CBOE Rule 6.45A, Interpretation and Policies .01 and .02 apply to complex orders on Hybrid.<sup>24</sup> Accordingly, a CBOE member seeking to trade with its customer's complex order would be required to comply with CBOE 6.45A, Interpretation and Policy .01, and a CBOE member seeking to cross its customer's complex order with solicited orders would be required to comply with CBOE Rule 6.45A, Interpretation and Policy .02.

In addition, the complex order priority provisions in CBOE Rules 6.45(e) and 6.45A(b)(iii) will continue to apply to complex orders. Accordingly, complex orders will be able to trade ahead of orders in the EBook or the limit order book only under the conditions specified in CBOE Rules 6.45(e) and 6.45A(b)(iii). The Commission also notes that complex orders from public customers will have priority over complex orders from non-public customers.<sup>25</sup>

The Commission finds good cause for approving Amendment Nos. 3 and 5 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. Amendment No. 3 merely clarifies the text of CBOE Rule 6.53C by indicating that conversions and reversals currently are not eligible for routing to the COB and that the CBOE will file any changes to this policy with the Commission pursuant to Rule 19(b)(3)(A) under the Act. Amendment No. 5 also clarifies the operation of the COB by indicating that the

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<sup>23</sup> See e.g., CBOE Rule 6.13(b)(i)(C)(ii) (allowing the appropriate FPC to determine, on a class-by-class basis, to allow orders from options market makers to be eligible for automatic execution on Hybrid); and CBOE Rule 7.4(a)(1) (allowing the appropriate FPC to determine on an issue-by-issue basis that orders from broker-dealers or from broker-dealers that are not options market makers are eligible for entry into the electronic book).

<sup>24</sup> See note 14, supra.

<sup>25</sup> See CBOE Rule 6.53C(c)(ii).

N-second timer will be temporarily set at zero. Accordingly, the Commission finds that it is consistent with Sections 6(b)(5) and 19(b) of the Act to approve Amendment Nos. 3 and 5 to the proposal on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 3 and 5, including whether Amendment Nos. 3 and 5 are consistent with the Act. 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-2004-45 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-45. 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. Copies of the

filing also will be available for inspection and copying at the principal office of the CBOE. 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-2004-45 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>26</sup> that the proposed rule change (SR-CBOE-2004-45), as amended, is approved, and that Amendment Nos. 3 and 5 are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>27</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>26</sup> 15 U.S.C. 78s(b)(2).

<sup>27</sup> 17 CFR 200.30-3(a)(12).