

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52823; File No. SR-CBOE-2005-90)

November 22, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated.; Notice of Filing of a Proposed Rule Change to Adopt a Simple Auction Liaison System to Auction Qualifying Marketable Orders for Potential Price Improvement

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 26, 2005, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend its rules to adopt a Simple Auction Liaison (“SAL”) system to auction qualifying inbound orders for potential price improvement.

Below is the text of the proposed rule change. Proposed new language is underlined.

Chicago Board Options Exchange, Incorporated

Rules

* * * * *

Rule 6.13. CBOE Hybrid System's Automatic Execution Feature

(a) No change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(b) Automatic Execution

(i) Eligibility: Orders eligible for automatic execution through the CBOE Hybrid System may be automatically executed in accordance with the provisions of this Rule or in accordance with Rule 6.13A for classes that have been designated for auction price improvement. This section governs automatic executions and split-price automatic executions. The automatic execution and allocation of orders or quotes submitted by market participants also is governed by Rules 6.45A(c) and (d).

(ii) -(iv) No change.

(c)- (e) No change.

* * * * *

Rule 6.13A Simple Auction Liaison (SAL)

This Rule governs the operation of the SAL system. SAL is a feature within the Hybrid System that auctions marketable orders for price improvement over the NBBO.

(a) SAL Eligibility. The Exchange, with input from the appropriate Floor Procedure Committee, shall designate the eligible order size, eligible order type, eligible order origin code (i.e. public customer orders, non-market maker broker-dealer orders, and market maker broker-dealer orders), and classes in which SAL shall be activated. For such classes, SAL shall automatically initiate an auction process for any order that is eligible for automatic execution by the Hybrid System pursuant to Rule 6.13 (“Agency Order”), except when the Exchange’s disseminated quotation contains one or more

resting limit orders and does not contain sufficient Market-Maker quotation size to satisfy the entire Agency Order.

(b) SAL Auction. Prior to commencing the auction, SAL shall stop the Agency Order at the NBBO against Market-Maker quotations displayed at the NBBO on the opposite side of the market as the Agency Order. SAL will not allow such quotations to move to an inferior price or size throughout the duration of the auction. The auction will last for a period of time not to exceed two (2) seconds as determined by the Exchange on a class-by-class basis. Auction responses may be submitted by Market-Makers with an appointment in the relevant option class and Members acting as agent for orders resting at the top of the Exchange's book opposite the Agency Order. With respect to responses, the following shall apply:

(i) Responses shall not be visible to other auction participants and shall not be disseminated to OPRA.

(ii) Responses may be submitted in one-cent increments.

(iii) Multiple responses are allowed.

(iv) Responses may be cancelled.

(v) Responses cannot cross the Exchange's disseminated quotation on the opposite side of the market.

(c) Allocation of Agency Orders. Agency Orders may be executed at multiple prices and shall be executed in two rounds per price point as follows:

(i) First Round Allocation. The Agency Order shall first be allocated at the prevailing price (the “First Allocation Round”) between all parties that represented the Exchange’s NBBO quotation at the time the auction commenced (“Original Quoters”) up to the size of such quotation. During the First Allocation Round, the following shall apply:

(1) the Agency Order shall be allocated pursuant to the matching algorithm in effect for the class pursuant to Rules 6.45A or 6.45B as appropriate;

(2) An Original Quoter may only participate in a First Round Allocation at each execution price up to its size at the NBBO at the time the auction commenced; and

(3) If the applicable matching algorithm includes a participation entitlement, then Market-Makers that qualify for a participation entitlement at the NBBO price will receive a participation entitlement if they match the executing auction price(s).

(ii) Second Allocation Round. If an Agency Order is not fully executed during the First Allocation Round at a particular price point, then a Second Allocation Round shall occur. During this round, all responses received during the auction at the prevailing auction price that were not eligible for the First Allocation Round shall participate in accordance with the matching algorithm in effect for the class, and the size of such responses shall be capped to the size of the Agency Order for

allocation purposes. There shall be no participation right during the Second Allocation Round.

(d) Early Termination of Auction. The auction will terminate early under the following circumstances:

(i) If the Hybrid System receives an unrelated non-marketable limit order on the opposite side of the market from the Agency Order that improves any auction responses, the unrelated order will trade (after any responses that were priced better than the unrelated order have traded) to the fullest extent possible at the midpoint of the best remaining auction response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary).

(ii) If the Hybrid System receives an unrelated market or marketable limit order on the opposite side of the market from the Agency Order, such unrelated order will trade to the fullest extent possible at the midpoint of the best auction response and the NBBO on the opposite side of the market from the auction responses (rounded towards the disseminated quote when necessary).

(iii) If the Hybrid System receives an unrelated order on the same side of the market as the Agency Order that is marketable against the NBBO, then the auction shall conclude and the Agency Order shall trade against the prevailing responses in accordance with subparagraph (c) above.

(iv) Any time there is a quote lock on the Exchange pursuant to Rule 6.45A(d).

(v) Any time a response matches the Exchange's disseminated quote on the opposite side of the market from the response.

...Interpretations and Policies:

.01 A pattern or practice of submitting unrelated orders that cause an exposure period to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 and other Exchange Rules.

.02 Disseminating information regarding auctioned orders to third parties will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 and other Exchange Rules.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE included statements concerning the purpose of and basis for the proposal and discussed any comments it received on the proposal. The text of these statements may be examined at the places specified in Item IV below. CBOE has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to implement SAL, a price improvement auction system for qualifying inbound orders. SAL is a feature within CBOE's Hybrid System that auctions marketable orders for price improvement over the National Best Bid or Offer ("NBBO"). Thus, orders that would otherwise be automatically executed at CBOE's NBBO market will be exposed to a brief auction in

penny increments for potential price improvement. SAL would not auction an order if CBOE were not the NBBO market at the time the order was received. As proposed, the Exchange would designate the eligible order size (e.g., all orders under 100 contracts), eligible order type (e.g., non-contingency orders), eligible order origin code (e.g., public customer orders, non-market maker broker-dealer orders, and market maker broker-dealer orders), and classes in which SAL shall be activated.

For eligible classes, SAL shall automatically initiate an auction process for any qualifying order (“Agency Order”) that is eligible for automatic execution by the Hybrid System except when the Exchange’s disseminated quotation contains one or more resting limit orders and does not contain sufficient quotation size from CBOE Market-Makers to satisfy the entire Agency Order. The reason SAL requires sufficient Market-Maker quote size in the NBBO quote to initiate a SAL auction is because SAL stops the Agency Order against the Market-Maker quotes. If CBOE’s NBBO price consisted only of resting limit orders, SAL could not stop the Agency Order against such limit orders because the limit orders might be cancelled prior to the conclusion of the auction.

As mentioned above, SAL stops the Agency Order at the NBBO against Market-Maker quotations displayed at the NBBO on the opposite side of the market as the Agency Order. In connection with this stop, SAL will not allow such quotations to move to an inferior price or size throughout the duration of the auction. The auction will last for a period of time not to exceed two (2) seconds as determined by the Exchange. Auction responses may be submitted by Market-Makers with an appointment in the relevant option class and by CBOE Members acting as agent for orders resting at the top of the Exchange’s book opposite the Agency Order. With respect to responses, the

following shall apply: (i) responses shall not be visible to other auction participants and shall not be disseminated to the Options Price Reporting Authority; (ii) responses may be submitted in one-cent increments (and not less than one-cent increments); (iii) multiple responses are allowed; (iv) responses may be cancelled prior to the conclusion of the auction; and (v) responses cannot cross the Exchange's disseminated quotation on the opposite side of the market.

At the conclusion of the auction period, the Agency Order will be executed at the best auction response prices and may be executed at multiple prices if necessary. The allocation of the execution of the Agency Order shall occur in two rounds at each price point. Participation in the first round (the "First Allocation Round") is limited to those that constituted the Exchange's NBBO quote (on the side of the market opposite the Agency Order) at the time the SAL auction commenced ("Original Quoters"). This is to encourage aggressive quoting and reward those that set the NBBO market. During the First Allocation Round, the following shall apply: (i) the Agency Order shall be allocated pursuant to the matching algorithm in effect for the class under Rules 6.45A or 6.45B as appropriate; (ii) Original Quoters may only participate in a First Allocation Round at each execution price up to their respective size at the NBBO at the time the auction commenced; and (iii) if the applicable matching algorithm includes a participation entitlement, then Market-Makers that qualified for a participation entitlement at the NBBO price will receive a participation entitlement in a First Allocation Round if they match the execution price for that round.

If an Agency Order is not fully executed during the First Allocation Round, then a second round ("Second Allocation Round") shall occur. During this round, all responses

received during the auction at the execution price of the immediately preceding First Allocation Round that were not eligible for that preceding round shall participate in accordance with the matching algorithm in effect for the class. The size of such responses shall be limited to the size of the Agency Order for allocation purposes. There is no participation right during the Second Allocation Round.

The following is an example of a SAL auction: The CBOE market of 1.00 - 1.10 is the NBBO. The 1.10 offer is for 300 contracts and is comprised of Market-Maker A for 100 contracts, Market-Maker B for 100 contracts and Market-Maker C for 100 contracts. A qualifying order is received to buy 100 contracts at 1.10. Instead of automatically executing the order at 1.10, SAL will auction the order. Assume the auction timer is set to one second. At the conclusion of the one-second auction, the following responses were received: Market-Maker A at 1.07 for 10 contracts and at 1.08 for 40 contracts; Market-Maker B at 1.08 for 40 contracts and at 1.09 for 100 contracts; and Market-Maker X at 1.07 for 10 contracts and at 1.08 for 100 contracts. The execution of the Agency order will proceed as follows: 10 contracts get filled at 1.07 against Market-Maker A, who is an Original Quoter; 10 contracts get filled at 1.07 against Market-Maker X, who is not an Original Quoter; and the remaining 80 contracts get filled against Market-Makers A and B (40 each) at 1.08. Market-Maker X does not participate at 1.08 since it is not an Original Quoter.

The following situations will cause the auction to conclude early. First, if the Hybrid System receives an unrelated non-marketable limit order on the opposite side of the market from the Agency Order that improves any auction responses, the auction will conclude and the unrelated order will trade (after any responses that were priced better

than the unrelated order have traded) to the fullest extent possible at the midpoint of the best remaining auction response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary). This will allow both the unrelated order and the Agency Order to obtain price improvement. Second, if the Hybrid System receives an unrelated market or marketable limit order on the opposite side of the market from the Agency Order, the auction will conclude and the unrelated order will trade to the fullest extent possible at the midpoint of the best auction response and the NBBO on the opposite side of the market from the auction responses (rounded towards the disseminated quote when necessary). This also provides price improvement to both orders. Third, if the Hybrid System receives an unrelated order on the same side of the market as the Agency Order that is marketable against the NBBO, then the auction will conclude and the Agency Order will trade against the responses at the highest price points. Fourth, the auction will conclude early any time there is a quote lock on the Exchange pursuant to Rule 6.45A(d). Fifth, the auction will conclude early any time a response matches the Exchange's disseminated quote on the opposite side of the market from the response.

Lastly, the Exchange seeks to adopt provisions providing that a pattern or practice of submitting unrelated orders that cause an auction to conclude early and disseminating information regarding such orders to third parties will be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1 and, potentially, other Exchange Rules.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act³ in general and furthers the objectives of Section 6(b)(5)⁴ in particular in that by swiftly providing potential price improvement over the NBBO to qualifying inbound orders, it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

³ 15 U.S.C. 78f(b).

⁴ 15 U.S.C. 78f(b)(5).

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is 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. Please include File Number SR-CBOE-2005-90 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2005-90. 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 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-2005-90 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁵

Jonathan G. Katz,
Secretary

⁵ 17 CFR 200.30-3(a)(12).