

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52928; File No. SR-CBOE-2005-89)

December 8, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto Relating to the Adoption of a Hybrid Agency Liaison System for Automated Handling of Inbound Orders That Are Not Automatically Executed

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 27, 2005, the Chicago Board Options Exchange, Inc. (“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 substantially prepared by the Exchange. CBOE filed Amendment No. 1 to the proposed rule change on December 7, 2005.³ The Commission is publishing this notice to solicit comment on the proposed rule change, as amended, from interested persons.

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

CBOE proposes to amend its rules to adopt a Hybrid Agency Liaison (“HAL”) system for automated handling of inbound orders. The text of the proposed rule change is set forth below.

Proposed new language is underlined.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced the original filing in its entirety.

Chicago Board Options Exchange, Incorporated

Rules

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Rule 6.13. CBOE Hybrid System's Automatic Execution Feature

(a) No change.

(b) Automatic Execution

(i)–(iii) No change.

(iv) Executions at NBBO: Eligible orders in classes that are multiply traded will not be automatically executed on CBOE at prices that are inferior to the NBBO and instead shall route to HAL, the PAR workstation in the trading crowd or, at the order entry firm's discretion, to BART. Eligible orders received while the CBOE market is locked (e.g., \$1.00 bid–\$1.00 offered) shall be eligible for automatic execution at CBOE's disseminated quote, provided that the disseminated quote is not inferior to the NBBO.

(c)–(e) No change.

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Rule 6.14 Hybrid Agency Liaison (HAL)

This Rule governs the operation of the HAL system. HAL is a feature within the Hybrid System that provides automated order handling in designated Hybrid option classes for qualifying electronic orders that are not automatically executed by the Hybrid System.

(a) HAL Eligibility. The Exchange, with input from the appropriate Floor Procedure Committee, shall designate the classes in which HAL shall be activated. For such classes, HAL shall automatically process upon receipt, as set forth in subparagraph (b) below, market and limit orders under the following circumstances:

(i) market orders or limit orders that are marketable against the Exchange's disseminated quotation while that quotation is not the NBBO;

(ii) limit orders that would improve the Exchange's disseminated quotation and that are marketable against quotations disseminated by other exchanges that are participants in the Intermarket Options Linkage; and

(iii) limit orders that would improve the Exchange's disseminated quotation.

(b) HAL Order Handling. Orders that are received by HAL pursuant to subparagraph (a) above shall immediately upon receipt be electronically exposed to all Market-Makers appointed to the relevant option class as well as all members acting as agent for orders at the top of the Exchange's book ("Qualifying Members") in the relevant option series. The exposure shall be for a period of time determined by the Exchange on a class-by-class basis, with input from the appropriate Floor Procedure Committee, which period of time shall not exceed 1.5 seconds. If during the exposure period, a Market-Maker or Qualifying Member (on behalf of the order it is representing) commits to trade with any portion of the order, then the exposure period shall end (the Exchange will disseminate a last sale report for the quantity committed to) and an allocation period shall commence (with additional last sale reports being immediately disseminated for any additional portions of the order that are committed to during this period). At no point will HAL execute an order, or any portion of an order, if such execution would cause a trade-through. The allocation period shall be a period of time determined by the Exchange on a class-by-class basis, with input from the appropriate Floor Procedure Committee, which period of time, when combined with the designated exposure period time (as opposed to an exposure period that is terminated early), shall not exceed a total of three (3) seconds. Allocation of the order shall be pursuant to subparagraph (c) below. If no responses are received during the

exposure period or if there remains an unexecuted portion of an order at the conclusion of the allocation period, then the order (the “Remaining Order”) shall be processed as follows:

(i) if the Remaining Order is for the account of a public customer and is marketable against another exchange that is a participant in the Intermarket Options Linkage, then HAL shall route a P/A Order on behalf of the Remaining Order through the Linkage and any resulting execution of the P/A Order shall be allocated to the Remaining Order. If the P/A Order cannot be transmitted from the Exchange because the price of the P/A Order (or a better price) is no longer available on any market, then HAL shall, pursuant to normal order allocation processing, execute the Remaining Order against the Exchange’s quote (provided such execution would not cause a trade-through) including, if appropriate, at the Exchange’s BBO at the time the order was received by HAL (“Exchange Initial BBO”) against the Market-Makers that constituted the Exchange Initial BBO;

(ii) if the Remaining Order is marketable against another exchange that is a participant in the Intermarket Options Linkage but is not for the account of a public customer, then HAL, when the system is enabled, shall route a Principal Order on behalf of the Remaining Order through the Linkage and any resulting execution of the Principal Order shall be allocated to the Remaining Order. If the Principal Order cannot be transmitted from the Exchange because the price of the Principal Order (or a better price) is no longer available on any market, then HAL shall, pursuant to normal order allocation processing, execute the Remaining Order against the Exchange’s quote (provided such execution would not cause a trade-through) including, if appropriate, at the Exchange Initial BBO at the time the order was received by HAL against the Market-Makers that constituted the Exchange Initial BBO. Until the HAL system is enabled to route Principal Orders, the Remaining Order shall route to PAR;

(iii) if the Remaining Order is not marketable (either on the Exchange or another exchange) it shall be entered into the Hybrid book for dissemination.

(c) Allocation of Exposed Orders. Each Market-Maker or Qualifying Member that submits an order or quote to trade with an order during the exposure or allocation periods shall be entitled to receive an allocation of the order in accordance with the allocation algorithm in effect for the option class pursuant to Rule 6.45A or 6.45B. There is no participation entitlement applicable to exposed orders, and response sizes are limited to the size of the exposed order for allocation purposes.

(d) Early Termination of Exposure Period. In addition to the receipt of a response to trade any portion of the exposed order, the exposure period will also terminate early under the following circumstances:

(i) If during the exposure period the Hybrid System receives an unrelated order on the opposite side of the market from the exposed order that could trade against the exposed order at the prevailing NBBO price, then the orders will trade. However, the exposure period shall not terminate for any quantity that remains on the exposed order after such trade;

(ii) If during the exposure period the Hybrid System receives an unrelated order on the same side of the market as the exposed order that is priced equal to or better than the exposed order, then the exposure period shall terminate and the exposed order shall be processed in accordance with subparagraph (b) (i), (ii) or (iii), as appropriate;

(iii) If during the exposure of an order that is marketable against the Exchange Initial BBO, a Market-Maker attempts to move its quote to a price that is inferior to the Exchange Initial BBO, then the exposure period shall terminate and the exposed order shall be processed in accordance with subparagraph (b) (i) or (ii), as appropriate.

(e) Early Termination of Allocation Period.

(i) If HAL is in the allocation stage of processing an order that has not been fully executed (i.e. all responses that have been received to that point cannot fully execute the order) and the Hybrid System receives an unrelated order on the opposite side of the market from the order that could trade against the order at the prevailing NBBO price, then the orders will trade. However, the allocation period shall not terminate with respect to any portion of the HAL order that did not execute against the unrelated order;

(ii) If HAL is in the allocation stage of processing an order that has not been fully executed (i.e. all responses that have been received to that point cannot fully execute the order) and the Hybrid System receives an unrelated order on the same side of the market as the order, then the allocation period shall terminate for the unexecuted portion of the order and the unexecuted portion of the order shall be processed in accordance with subparagraph (b) (i), (ii) or (iii), as appropriate;

(iii) If HAL is in the allocation stage of processing an order that is marketable against the Exchange Initial BBO and a Market-Maker attempts to move its quote to a price that is inferior to the Exchange Initial BBO while any portion of the order remains unexecuted (i.e. all responses that have been received to that point cannot fully execute the order), then the allocation period shall terminate and the unexecuted portion of the order shall be processed in accordance with subparagraph (b) (i) or (ii), as appropriate.

...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 exposed 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.

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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 HAL, a new order handling system for option classes trading on CBOE's Hybrid System ("Hybrid"). Hybrid provides electronic executions for orders that are marketable against the Exchange's quote when it is priced at the National Best Bid or Offer ("NBBO"). The entire process for those orders is automated; however, many electronically-received orders that are not automatically executed upon receipt by the Hybrid System (usually because CBOE's disseminated quote is not the NBBO) are routed to a PAR terminal for manual handling. Proposed CBOE Rule 6.14 is meant to automate the process of handling most orders that would otherwise go to PAR.

Currently, if the Exchange receives a marketable order when its disseminated quote is not the NBBO, the order routes to PAR where it must be selected by the PAR Official (there may be multiple orders on PAR at the same time) and then represented to the trading crowd in open-

outcry. The order is represented to determine if any trading crowd members are willing to step up and match the NBBO price available on another exchange. If there is interest in the crowd to match the NBBO, then the order will be manually filled. If there is no interest in matching the NBBO price, an order will be generated and transmitted via the Intermarket Option Linkage (“Linkage”) to the NBBO market on behalf of the order on PAR. If the Linkage order is filled, that fill will be transferred to the order on PAR. While all of this is done relatively quickly, the HAL system would automate this process and reduce the timing to a matter of seconds (in no case more than three seconds). The following is an explanation of how HAL would work.

HAL would only be available for classes trading on Hybrid. The Exchange, with input from the appropriate Floor Procedure Committee, would designate the Hybrid classes for which HAL would be activated. For those classes, HAL would process (i) market orders or limit orders that are marketable against CBOE’s disseminated quote while that quote is not the NBBO; (ii) limit orders that would improve the Exchange’s disseminated quote and that are marketable against quotes disseminated by other exchanges that are participants in the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (“Linkage Plan”); and (iii) limit orders that are not marketable against the NBBO but that would improve CBOE’s disseminated quote. These orders would be electronically exposed (flashed) to all Market-Makers appointed to the relevant option class as well as to all members acting as agent for orders at the top of the Exchange’s book in the relevant option series (“Qualifying Members”).⁴ Like with open outcry, this flash would afford crowd members an opportunity to match the away NBBO price.

⁴ Of course, eligible recipients of these “flash” messages may need to undertake some programming modifications in order to receive and respond to these messages. The Exchange will not require those programming changes.

HAL's first step in flashing an order would be to gauge if there is any interest from any Market-Maker or Qualifying Member in matching the away NBBO price, or, in the case of a limit order that improves CBOE's quote but is not marketable, in filling the order instead of booking it. This step is called the exposure period. The exposure would be for a period of time determined by the Exchange on a class-by-class basis, with input from the appropriate Floor Procedure Committee, which period of time would not exceed 1.5 seconds. If during the exposure period, a Market-Maker or Qualifying Member (on behalf of the order it is representing) commits to trade with any portion of the order, then the exposure period would end (with a last sale report being issued for the quantity that was traded) and an allocation period would begin.

The allocation period affords other participants that were attempting to trade with the exposed order a chance to participate in the execution of the order. The allocation period would be a period of time determined by the Exchange on a class-by-class basis, with input from the appropriate Floor Procedure Committee, which period of time, when combined with the designated exposure period time (as opposed to an exposure period that is terminated early), would not exceed a total of three seconds. For example, if the exposure period is set to 1.5 seconds, the allocation period cannot exceed 1.5 seconds. If the exposure period is set for one second, the allocation period cannot exceed two seconds. Of course, in that case the Exchange could determine to set the allocation period at one second or anything less than two seconds (i.e., the entire HAL process does not have to equal three seconds). Further, if an exposure period for a given order is terminated early, the "unused balance" of the exposure period is not added to the allocation period.

Exposed orders would be allocated at the conclusion of the allocation period in accordance with the allocation algorithm in effect for the option class pursuant to CBOE Rule

6.45A or 6.45B. There is no participation entitlement applicable to exposed orders, and response sizes are limited to the size of the exposed order for allocation purposes.

If no responses are received during the exposure period or if there remains an unexecuted portion of an order at the conclusion of the allocation period, then the order (the “Remaining Order”) would be booked if it is a limit order that is not marketable, or processed in one of the following two ways, based on whether the order is for the account of a public customer. First, if the Remaining Order is for the account of a public customer and is marketable against another exchange that is a participant in the Linkage Plan, then HAL would route a Principal Acting as Agent Linkage Order (“P/A Order”) on behalf of the Remaining Order through the Linkage and any resulting execution of the P/A Order would be allocated to the Remaining Order. Second, if the Remaining Order is marketable against another exchange that is a participant in the Linkage Plan but is not for the account of a public customer, then HAL, when the system is enabled, would route a Principal Linkage Order (“P Order”) on behalf of the Remaining Order through the Linkage, and any resulting execution of the P Order would be allocated to the Remaining Order.⁵ Until the HAL system is enabled to route P Orders, the Remaining Order would route to PAR.

In either of these situations, if the Linkage order cannot be transmitted from the Exchange because the price of the Linkage order (or a better price) is no longer available on any market, then HAL would, pursuant to normal order allocation processing, execute the Remaining Order against the Exchange’s quote (provided such execution would not cause a trade-through), including, if appropriate, at the Exchange’s best bid or offer at the time the order was received by

⁵ When routing Linkage orders (whether P or P/A), the Exchange may choose to route only up to the available size at the NBBO as allowable under the “trade and ship” process of the Linkage Plan.

HAL (“Exchange Initial BBO”) against the Market-Makers that constituted the Exchange Initial BBO. HAL would effect executions against Market-Makers at the Exchange Initial BBO by preventing Market-Makers from moving Exchange Initial BBO quotes to inferior prices until a HAL order has been executed on CBOE or routed through Linkage.

The Exchange notes that, in addition to the receipt of a response to trade any portion of the exposed order, the exposure period would terminate early under the following circumstances. First, if during the exposure period the Hybrid System received an unrelated order on the opposite side of the market from the exposed order that could trade against the exposed order at the prevailing NBBO price, then the orders would trade. However, the exposure period would not terminate if a quantity remains on the exposed order after such trade. Second, if during the exposure period the Hybrid System received an unrelated order on the same side of the market as the exposed order that was priced equal to or better than the exposed order, then the exposure period would terminate and the exposed order would be processed in the same manner as an exposed order for which no response to trade was received during the full exposure period—i.e., routed through the Linkage or booked, in accordance with proposed CBOE Rule 6.14(b)(i), (ii), or (iii), as appropriate. Third, if during the exposure of an order that is marketable against the Exchange Initial BBO a Market-Maker attempted to move its quote to a price that was inferior to the Exchange Initial BBO, then the exposure period would terminate and the exposed order would be processed in the same manner as an exposed order for which no response to trade was received during the full exposure period. Meanwhile, the Exchange would not permit any Market-Maker quotes to move to an inferior price until the exposed order was routed through Linkage or, if necessary, executed against Market-Makers at the Exchange Initial BBO.

Similarly, if HAL were in the allocation stage of processing an order that has not been fully executed (i.e., an order that was partially “hit” during the exposure period and for which all

responses received to that point could not fully execute the order), the allocation period would terminate early under the following circumstances. First, if the Hybrid System received an unrelated order on the opposite side of the market from the HAL order that could trade against the HAL order at the prevailing NBBO price, then the orders would trade. However, the allocation period would not terminate with respect to any quantity that did not execute against the unrelated order. Second, if the Hybrid System received an unrelated order on the same side of the market as the HAL order, then the allocation period would terminate for the unexecuted portion of the order and the unexecuted portion of the order would be processed in the same manner as an exposed order for which no response to trade was received during the full exposure period—i.e., routed through the Linkage or booked, in accordance with proposed CBOE Rule 6.14(b)(i), (ii), or (iii), as appropriate. Third, if HAL were in the allocation stage of an order that is marketable against the Exchange Initial BBO and a Market-Maker attempted to move its quote to a price that was inferior to the Exchange Initial BBO while any portion of the order remained unexecuted (i.e., all responses that have been received to that point cannot fully execute the order), then the allocation period would terminate and the unexecuted portion of the order would be processed in the same manner as an exposed order for which no response to trade was received during the full exposure period.

Finally, the Exchange proposes that a pattern or practice of submitting unrelated orders that cause an exposure period to conclude early and disseminating information regarding exposed orders to third parties would be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1 and other Exchange Rules.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act⁶ in general, and furthers the objectives of Section 6(b)(5) of the Act⁷ in particular, in that 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 Exchange consents, the Commission will:

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

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

⁶ 15 U.S.C. 78f(b).

⁷ 15 U.S.C. 78f(b)(5).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2005-89 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2005-89. 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 such filing 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-2005-89 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.⁸

Jonathan G. Katz
Secretary

⁸ 17 CFR 200.30-3(a)(12).