

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-53112; File No. SR-CBOE-2004-21)

January 12, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change to Establish Rules for a Screen-Based Trading System for Non-option Securities

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> notice is hereby given that on April 14, 2004, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the Exchange. On January 11, 2006, CBOE submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments 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 adopt rules governing the trading of non-option securities on CBOEdirect, the Exchange’s screen-based trading platform. The proposed new system would be called the Stock Trading on CBOEdirect System (“STOC System” or “System”). The text of the proposed rule change is available at CBOE’s Web site (<http://www.cboe.org/legal/default.aspx>), at CBOE’s principal office, and at the Commission’s Public Reference Room.

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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. 1 replaced the original rule filing in its entirety.

## **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 proposed rule change and discussed any comments it received on the proposed rule change. 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**

As an Intermarket Trading System ("ITS") participant, CBOE trades a small number of non-option securities.<sup>4</sup> These products are not traded on CBOE's options trading platform. Instead, they trade on CBOE's stand-alone stock platform in an open-outcry environment pursuant to Chapter XXX (30) of CBOE's rules. In 2003, the Commission approved Chapters XL (40) through XLVI (46) of CBOE's rules,<sup>5</sup> which established a purely screen-based trading platform for the trading of options on CBOE.<sup>6</sup> That screen-based platform is commonly referred to as CBOEdirect, and components of that system have been successfully used to create CBOE's Hybrid Trading System (currently in use for options trading), to facilitate the trading of single-stock futures by OneChicago, and to trade security futures products on the newly-created CBOE

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<sup>4</sup> Currently, CBOE trades four such products.

<sup>5</sup> See Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (approving SR-CBOE-00-55); see also Securities Exchange Act Release No. 45829 (April 25, 2002), 67 FR 31002 (May 8, 2002) (notice of filing of SR-CBOE-00-55).

<sup>6</sup> At this time, CBOE does not trade options pursuant to Chapters 40-46.

Futures Exchange.<sup>7</sup> CBOE now proposes to adopt a new set of rules as Chapters L (50) through LV (55) of CBOE's rules to allow for the trading of non-option securities in a purely screen-based environment. CBOEdirect would be the foundation for this platform. CBOE intends that all products currently traded under Chapter 30 would migrate to the new platform and trade pursuant to Chapters 50-55. The proposed new platform is called the Stock Trading on CBOEdirect System, or STOC System. The STOC System would be substantially similar to CBOE's screen-based platform for options in that it (1) would be entirely screen-based; (2) would utilize a DPM/LMM-driven model with optional supplemental liquidity provided by STOC Market-Makers; (3) would utilize a configurable matching algorithm based on either price-time or pro-rata priority with optional priority overlays; and (4) would integrate all quotes and orders entered into the system into the STOC book.

CBOE believes the STOC System would greatly enhance the trading of stock products on the Exchange. Unlike CBOE's current non-option security trading system, the STOC System would be fully integrated with ITS to facilitate the sending and receipt of ITS Commitments. It would automatically execute marketable orders against CBOE's quote up to the size of the quote (assuming such executions would not cause an impermissible trade-through of another exchange's quote). STOC Market-Maker quotes and all orders (customer or otherwise) would be integrated into the STOC Book. Further, the audit trail process would be greatly simplified for regulatory purposes.

Almost all of the rules contained in proposed Chapters 50-55 are substantially identical to previously approved rules contained in Chapters 30 and 40-46 of CBOE's rules. Of course, not all the rules from those chapters are proposed to be adopted for the STOC System rules—only

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<sup>7</sup> CBOE represents that these different uses of the CBOEdirect platform have not had, and

ones that would be appropriate for screen-based stock trading. Any new rules or material modifications to the rules proposed to be adopted from Chapters 30 and 40-46 are explained below.

### **Chapter 50**

This chapter provides an introduction to the STOC System by setting forth definitions (including definitions of the various market participant types), explaining the application of other CBOE rules, setting forth the registration process for members,<sup>8</sup> stating communication access guidelines, and establishing a limitation on liability with respect to certain reporting authorities. All of the rules in this chapter come from Chapters 40 and 41 of CBOE's rules, except for proposed CBOE Rule 50.7, Limitation on Reporting Authorities' Liability, which is based on CBOE Rule 30.55.

### **Chapter 51**

This chapter contains rules concerning operational matters—for example, business hours, units of trading, minimum increments for bids and offers, and types of orders handled. Proposed CBOE Rules 51.1, 51.2, 51.4, 51.5, 51.7, and 51.8 through 51.11 are rules that can also be found in Chapter 30. CBOE Rule 51.3 is based on current CBOE Rule 42.2.

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will not have, an adverse affect on trading or the stability of the platform.

<sup>8</sup> With respect to the registration process for members, any Exchange member who chooses to participate on the STOC System must apply with the Exchange to act as a STOC Market-Maker, STOC Broker, or Proprietary Trader in accordance with proposed CBOE Rule 50.4. Such applications must be submitted to the Exchange Membership Committee for approval pursuant to CBOE Rule 3.9. CBOE Rule 3.9 provides that an applicant must submit an application in a form and manner prescribed by the Exchange and describes the application procedures and process for approval or disapproval.

## **Chapter 52**

This chapter contains proposed trading and order processing rules for the STOC System. Proposed CBOE Rule 52.1 describes the System's matching algorithm and governs priority on the System. It is similar to CBOE Rule 43.1, which governs priority for options orders. As proposed, the appropriate STOC Trading Committee would apply one of two priority schemes, on a security-by-security basis. Trades would be allocated by the System pursuant to either price-time priority or pro-rata priority. Once one of those two priority schemes is in place, the appropriate STOC Trading Committee could implement additional optional priority overlays. Namely, an additional priority could be provided to public customer orders, the market turner, or to the STOC DPM/LMM (CBOE's specialist equivalent)<sup>9</sup> as part of a participation entitlement.<sup>10</sup> Thus, if pro-rata priority were in place for a particular security, and the market turner, public customer, and trade participation right overlays were in place (in that order of priority), incoming marketable orders would be allocated by the System to all participants in pro-rata fashion after the participant that first established that price (the market turner), any public customers resting at the best price, and the STOC DPM/LMM for the product (assuming its order and/or quote is at the best price) have been satisfied (in that order). As part of the participation right, the STOC DPM/LMM could never receive a quantity larger than the size of its quote. The participation right percentage would be established pursuant to proposed CBOE Rule 53.56 by the STOC

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<sup>9</sup> Throughout the proposed rules, references to STOC DPMs are also applicable to STOC LMMs (which are essentially rotating STOC DPMs). A product cannot have both a STOC DPM and a STOC LMM appointed to it. See proposed CBOE Rule 53.51 (defining STOC LMM).

<sup>10</sup> Proposed CBOE Rule 52.1(b)(3)(C) provides that the participation entitlement may not be in effect unless the public customer priority is in effect and ahead of the participation entitlement in the priority sequence.

DPM Committee and could not exceed 40%. Any participant (including a public customer) could be a market turner.

Proposed CBOE Rule 52.2 would govern the System's opening procedures. The opening would occur in one of two ways, depending on whether CBOE was the primary market for a security. If CBOE were the primary market, the System would calculate a price point at which the most pre-opening buy and sell orders could be matched (based on share volume) and then execute those orders to establish an opening price and open trading. If CBOE were not the primary market, the STOC DPM/LMM would open the security at a single price that matches the primary market or at a price that does not trade-through another exchange's quotes. This would allow the STOC DPM to assess the quantity and balance of pre-opening orders and to interact with the primary market as necessary via ITS.

Proposed CBOE Rule 52.4 would govern "clearly erroneous" transactions executed on the Exchange. The proposed rule sets forth the procedure for requesting Exchange review, the review procedures, and the steps taken in the event of system disruption or malfunction. The Exchange notes that this proposed rule is based on PCX Equities ("PCXE") Rule 7.10, which governs clearly erroneous executions.

Proposed CBOE Rule 52.6 would govern market order processing. It provides that market orders would automatically execute against the STOC Book (including against orders behind the best price at varying price points) until the order is fully executed or until such execution would result in an impermissible trade-through.<sup>11</sup> To the extent a market order is not

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<sup>11</sup> In most cases any trade-through would be impermissible, but the Commission has provided a temporary 3-tick exemption for certain products. See Securities Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 4, 2002) (order implementing the exemption as a pilot program); Securities Exchange Act Release No. 52382 (September 6, 2005), 70 FR 53695 (September 9, 2005) (order extending pilot

automatically executed against the STOC book because CBOE is not the NBBO, the System would “flash” the order at the NBBO price to STOC Market-Makers on the System (to see if they would match or improve the NBBO) for a period of time not to exceed three seconds. After such time, if the order has not been traded, the System will route it to the STOC DPM/LMM for manual handling (which would allow the DPM/LMM to transmit an ITS commitment on behalf of the order).

Proposed CBOE Rule 52.7, which would govern limit order processing, provides that limit orders would be booked by the System and that they would not automatically execute at prices inferior to the NBBO. When a limit order is received that is marketable against the quote of another exchange but not marketable on CBOE, the System would “flash” the order at its limit price to STOC Traders on the System (to see if they would match or improve the NBBO) for a period of time not to exceed three seconds. After such time, if the limit order has not been traded, the System would route it to the STOC DPM/LMM for manual handling (which would allow the DPM/LMM to transmit an ITS Commitment on behalf of the limit order).

Proposed CBOE Rule 52.8 provides that market odd-lot orders would be executed against STOC Market-Maker interest on the STOC Book provided such interest equals the NBBO. If no STOC Market-Makers are quoting at the NBBO, odd-lot orders would route to the STOC DPM/LMM for execution. Limit odd lot orders would execute against the STOC DPM/LMM if (i) the limit price is marketable against the STOC DPM/LMM quote, or (ii) a trade occurs at the

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program through June 28, 2006). Any such exemption would be factored into what can automatically execute on the STOC System.

limit price on another exchange. Pre-opening odd lot orders that are marketable against the opening price would receive the opening price.

Proposed CBOE Rule 52.10 would provide that the System would automatically execute inbound ITS Commitments against the best prices available in the STOC Book to the extent such commitments are marketable. When an ITS Commitment is not marketable against the STOC Book, the System would “flash” the commitment at its limit price to STOC Traders on the System (to see if they would match or improve the NBBO) for a period of time not to exceed 3 seconds. After such time, any unexecuted portion would be cancelled by the System. Inbound market ITS Commitments would be executed at the NBBO or cancelled.

Proposed CBOE Rule 52.11(a) governs the facilitation of the non-option security portion of option-related complex orders. This rule defines a complex order as an order involving one or more option order components and one or more non-option security order components. Such facilitation transactions would be entered into the STOC System at a price at or within the prevailing quotation for the non-option security at the time the options portion of the complex orders are executed. The non-option security portion of the order would have priority at that price irrespective of pre-existing bids and offers and any priority designations in place pursuant to proposed CBOE Rule 52.1, provided that the option order component(s) bettered the corresponding bid (offer) in the options market on which they were executed.

Proposed CBOE Rule 52.11(b), regarding crossing transactions on the STOC System, provides that a STOC Trader that wishes to cross two original orders or to facilitate an original order must first send a Request for Quote (RFQ) with size. Within 10-30 seconds, as determined by the appropriate STOC Trading Committee, from the conclusion of the RFQ response period, the orders may, at the STOC Trader’s discretion, be crossed (i) between the bid-offer if the



transaction would be less than 25,000 shares; or (ii) at or between the bid-offer if the transaction would be greater than 25,000 shares and in which case the cross transaction will have priority.

The cross transaction information would be received and effected by the Exchange's Help Desk.

The remaining rules in proposed Chapter 52 are taken from existing CBOE rules. CBOE Rule 52.3 (Unusual Market Conditions) is based on existing CBOE Rule 30.5, and CBOE Rules 52.5 (Order Entry and Maintenance), 52.13 (Firm Quotations), and 52.14 (Quote and Trading Information) are based on rules contained in Chapter 30. CBOE Rule 52.9 (Processing of Requests for Quotes) is based on existing CBOE Rule 43.11.

### **Chapter 53**

The chapter relates to requirements and obligations of members, both generally and by participant type (e.g., STOC DPM, STOC Broker, etc.). Proposed Section A carries over Chapter 30 rules that currently apply to all members trading non-option securities on CBOE. They relate to matters such as trading in member accounts, members acting as brokers, short sale requirements, and doing business with the public.

Proposed Section B contains provisions that are applicable to all STOC Market-Makers (including STOC DPMs/LMMs). These provisions are based on similar provisions that apply to SBT Market-Makers trading options under Chapters 40-46. Accordingly, the registration and appointment process for STOC Market-Makers is identical to the process in place for SBT Market-Makers. Further, STOC Market-Maker obligations, as set forth in proposed CBOE Rule 53.23, are centered on RFQ response requirements. STOC Market-Makers that are not providing a two-sided quote at the time of an RFQ would have to respond to the RFQs with a two-sided market that must last in duration for at least 30 seconds (unless traded) and for a minimum size designated by the appropriate STOC Market Performance Committee. As part of

their obligations, STOC Market-Makers would be required to respond to at least 75% of all RFQs in their appointed securities.

Proposed Section C sets forth additional considerations and requirements applicable to STOC DPMs and LMMs. As previously stated, a STOC LMM essentially would be a rotating STOC DPM. There would never be a STOC DPM and STOC LMM for the same security. As with the STOC Market-Maker provisions, these provisions are patterned after rules in Chapter 44. STOC DPMs/LMMs would be required to provide continuous two-sided markets in assigned securities and to handle customer orders received by the STOC System that are not automatically executed or booked. Thus, STOC DPMs/LMMs would have dealer and agent functions and obligations.

Proposed Sections D and E relate to definitions and requirements applicable to STOC Brokers and Clearing Firm Brokers. These provisions are identical to provisions in Chapter 45.

### **Chapters 54 and 55**

Proposed Chapter 54 sets forth additional provisions that would be applicable to certain product types that could trade on the STOC System. These product types, which include index portfolio receipts (IPRs)<sup>12</sup> and Index Portfolio Shares (IPSs),<sup>13</sup> are currently available for trading on CBOE under Chapter 30. All of the proposed rules in this Chapter are identical to rules contained in Chapter 30. Proposed Chapter 55 contains CBOE's ITS-related rules, which are modeled on PCXE's ITS rules. CBOE deemed those an appropriate model because, like the proposed STOC system, PCXE is an all-electronic trading platform. Lastly, CBOE is attaching

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<sup>12</sup> See CBOE Rule 1.1, Interpretations and Policies .02.

<sup>13</sup> See CBOE Rule 1.1, Interpretations and Policies .03.

an index to Chapters 50-55 to set forth the applicability of other CBOE rules to trading under Chapters 50-55.

### **Conclusion**

CBOE believes that the proposed migration of trading of non-option securities to the STOC System would significantly enhance the trading of these products on the Exchange. CBOE proposes that Chapters 50-55 be approved on a pilot basis for a period commencing on the approval date of this filing and ending on the final compliance date for the Order Protection Rule of Regulation NMS.<sup>14</sup> CBOE acknowledges that it will need to file additional rule changes to comply with Regulation NMS,<sup>15</sup> and the Exchange commits to submitting such filings in a timely manner.

## **2. Statutory Basis**

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Exchange Act in general and furthers the objectives of Section 6(b)(5) in particular in that it would enhance the trading of non-option securities on CBOE and 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 believes that the proposed rule change would not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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<sup>14</sup> 17 CFR 242.611.

<sup>15</sup> See generally Securities Exchange Act Release 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (order adopting rules under Regulation NMS).

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

The Exchange neither solicited nor received comments 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, as amended, or
- (B) institute proceedings to determine whether the proposed rule change, as amended, 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, 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 email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-21 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2004-21. This file number should be included on the subject line if email 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 Section. 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 only submit information you

wish to make available publicly. All submissions should refer to File Number SR-CBOE-2004-21 and should be submitted on or before [insert date 21 days after the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

Nancy M. Morris  
Secretary

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<sup>16</sup> 17 CFR 200.30-3(a)(12).