

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-53229; File No. SR-CBOE-2006-12)

February 6, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Bid/Ask Differentials in CBOE Rule 8.7

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 January 31, 2006, 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 and II below, which Items have been prepared by the Exchange. The CBOE has filed this proposal pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the Commission.<sup>5</sup> 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 CBOE proposes to amend CBOE Rule 8.7, "Obligations of Market Makers," to modify the bid/ask differential rules for options trading in open outcry and on the CBOE's Hybrid System ("Hybrid") and Hybrid 2.0 Platform ("Hybrid 2.0").<sup>6</sup> The text of the proposed

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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> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>5</sup> The CBOE has asked the Commission to waive the five-day pre-filing requirement and the 30-day operative delay provided in Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

<sup>6</sup> Hybrid is the CBOE's trading platform that allows individual Market Makers to submit electronic quotes in their appointed classes. Hybrid 2.0 is an enhanced trading platform

rule change appears below. Proposed new language is underlined; proposed deletions are bracketed.

**Rule 8.7 – Obligations of Market-Makers**

Rule 8.7. (a) No change

(b) Appointment. With respect to each class of option contracts for which he holds an Appointment under Rule 8.3, a Market-Maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. Without limiting the foregoing, a Market-Maker is expected to perform the following activities in the course of maintaining a fair and orderly market:

(i) – (iii) No change

(iv) To price options contracts fairly by, among other things, bidding and/or offering in the following manner:

(A) Bidding and Offering in Open Outcry. With respect to all option classes traded on the Exchange, bids and offers made in open outcry shall be priced so as to create differences of no more than \$0.25 between the bid and offer for each option contract for which the bid is less than \$2, no more than \$0.40 where the bid is at least \$2 but does not exceed \$5, no more than \$0.50 where the bid is more than \$5 but does not exceed \$10, no more than \$0.80 where the bid is more than \$10 but does not exceed \$20, and no more than \$1 where the bid is more than \$20, provided that the [appropriate

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that allows remote quoting by authorized categories of members. See CBOE Rule 1.1(aaa).

Market Performance Committee] Exchange may establish differences other than the above for one or more options series. The bid/ask differentials stated above shall not apply to in-the-money series where the quote width (i) on the primary market of the underlying security[ies market], or (ii) calculated by the Exchange or its agent for various indices pursuant to Interpretation .08 of Rule 8.7, as applicable, is wider than the differentials set forth above. For these series, the bid/ask differential may be as wide as the quotation on the primary market of the underlying security or calculated by the Exchange or its agent for various indices, as applicable.

(B) Opening Rotations. The provisions of Rule 8.7(b)(iv)(A) shall apply during the applicable opening rotation employed in Hybrid classes, Hybrid 2.0 classes, and Non-Hybrid and Non-Hybrid 2.0 classes.

([A]C) Option Classes Trading on the Hybrid Trading System and Hybrid 2.0 Platform. Except as provided in subparagraphs (i) and (ii) below, [O]option[s] [on] classes trading on the Hybrid Trading [s]System and the Hybrid 2.0 Platform may be quoted electronically with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid. [The \$5 quote widths shall only apply to classes trading on the Hybrid system and only following the opening rotation in each security (i.e., the widths specified in paragraph (b)(iv) above shall apply during opening rotation).] The provisions of Rule 8.7(b)(iv)(A) shall apply to any [Q]quotes given in open outcry in Hybrid classes and Hybrid 2.0 classes[may not be quoted with \$5 widths and instead must comply with the legal width requirements (e.g., no more than \$0.25 between the bid and offer for each option contract for which the bid is less than \$2) described in paragraph (iv) and not subparagraph (iv)(A)].

- i. The \$5 bid/ask differential stated in subparagraph (C) above shall not apply to in-the-money series where the quote width on the primary market of the underlying security, or the quote width calculated by the Exchange or its agent for various indices pursuant to Interpretation .08, is wider than \$5. For these series, the bid/ask differential may be as wide as the quote width on the primary market of the underlying security or calculated by the Exchange or its agent, as applicable; and
- ii. The Exchange may establish quote width differences other than as provided in subparagraph (C) for one or more option series.

(c) – (e) No change.

**... Interpretations and Policies:**

**.01 – .13** No change

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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, the Exchange 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. The Exchange 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 CBOE proposes to make a number of changes to its rules relating to bid/ask differentials as described below, including reorganizing CBOE Rule 8.7(b)(iv) to set forth in separate paragraphs the applicable bid/ask differentials in open outcry, during the opening rotation, and for option classes trading on Hybrid or Hybrid 2.0.

CBOE Rule 8.7(b)(iv) establishes maximum bid/ask differentials (also referred to as quote spread requirements) for Market Makers that vary depending upon the price of the option class and the trading platform on which the option class trades (e.g., Hybrid, Non-Hybrid). For bids and offers in open outcry, the allowable bid/ask differentials are currently no more than \$0.25 when the bid is less than \$2, no more than \$0.40 when the bid is at least \$2 but does not exceed \$5, no more than \$0.50 where the bid is more than \$5 but does not exceed \$10, no more than \$0.80 when the bid is more than \$10 but does not exceed \$20, and no more than \$1 where the bid is more than \$20. CBOE Rule 8.7(b)(iv) provides that the Exchange may establish differences other than the above for one or more option series.<sup>7</sup> Additionally, CBOE Rule 8.7(b)(4) provides that the differentials stated above do not apply to in-the-money-series where the underlying securities market is wider than the above; for those series, the differential may be as wide as the quotation on the primary market of the underlying security. With respect to option classes trading on Hybrid or Hybrid 2.0, bids and offers may be quoted electronically with a difference not to exceed \$5 following the opening rotation regardless of the price of the bid.

With respect to the bid/ask differentials in open outcry, the CBOE is proposing to amend CBOE Rule 8.7(b)(iv) to modify the existing allowable bid/ask differentials as follows. The proposed rule change maintains in amended paragraph (A) of CBOE Rule 8.7(b)(iv) the existing provisions of CBOE Rule 8.7(b)(iv) which allow the bid/ask differentials for in-the-money series

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<sup>7</sup> The CBOE proposes to amend CBOE Rule 8.7(b)(iv) to substitute the Exchange for the appropriate Market Performance Committee.

to be quoted in open outcry as wide as the quotation in the underlying securities market.

Additionally, the Exchange proposes to cross reference in amended CBOE Rule 8.7(b)(iv)(A) the provisions of CBOE Rule 8.7, Interpretation and Policy .08, pertaining to bid/ask differentials for index options as to which the Exchange or its authorized agent calculates bids and asks.<sup>8</sup> Thus, under CBOE Rule 8.7(b)(iv)(A), as amended, the bid/ask differentials for in-the-money series of index options may be as wide as the bid/ask differential calculated by the CBOE or its authorized agent pursuant to CBOE Rule 8.7, Interpretation and Policy .08.

The proposed rule change also establishes a new paragraph (B) under CBOE Rule 8.7(b)(iv), which provides that the provisions of CBOE Rule 8.7(b)(iv)(A), as amended, shall apply during the opening rotation in Hybrid classes, Hybrid 2.0 classes, and non-Hybrid and non-Hybrid 2.0 classes. As noted above, CBOE Rule 8.7(b)(iv)(A), as amended, sets forth the permissible bid/ask differentials for trading in open outcry. The CBOE states that new paragraph (B) of CBOE Rule 8.7(b)(iv) is consistent with the CBOE's existing rules pertaining to the permissible bid/ask differentials that apply during the opening rotation.<sup>9</sup> Thus, according to the CBOE, this proposed modification does not make any substantive changes to the CBOE's existing rules relating to the permissible bid/ask differentials during the opening rotation.

New paragraph (C) of CBOE Rule 8.7(b)(iv) contains the permissible quote width differentials that apply to option classes trading on Hybrid and Hybrid 2.0. These quote width

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<sup>8</sup> CBOE Rule 8.7, Interpretation and Policy .08, provides that the Exchange or its authorized agent may calculate bid/ask values for various indexes for the sole purpose of determining permissible bid/ask differentials on options on those indexes.

<sup>9</sup> For example, CBOE Rule 6.2B, "Hybrid Opening System," provides that in calculating an Expected Opening Price during the opening, the quote of the Designated Primary Market Maker or at least one Market Maker or Lead Market Maker with an appointment in an options class must be present and comply with the legal width quote requirements of current CBOE Rule 8.7(b)(iv). In addition, CBOE Rule 8.7(b)(iv)(A) currently provides that for classes trading on Hybrid, the quote widths in CBOE Rule 8.7(b)(iv) apply during the opening rotation in each security.

differentials were previously contained in CBOE Rule 8.7(b)(iv)(A). New paragraph (C) makes clear that the quote width differentials that apply to options classes trading on Hybrid are equally applicable to option classes trading on Hybrid 2.0. In addition, proposed new CBOE Rule 8.7(b)(iv)(C)(i) provides that the quote widths for in-the-money series of options classes trading on Hybrid and Hybrid 2.0 may be as wide as the quote width of the underlying security or index reported by the Exchange or its agent, as applicable, when that quote width is greater than \$5. The CBOE states that these provisions are identical to International Securities Exchange ("ISE") Rule 803(b)(4).

Additionally, proposed new paragraph (C) would permit the Exchange to establish permissible quote width differentials other than as provided in CBOE Rule 8.7(b)(iv)(C). For example, the Exchange may determine to grant bid/ask relief in the event of unusual circumstances, such as a pending merger or acquisition of an underlying security, a distribution of a special cash dividend, or other unusual circumstances. The CBOE believes that granting the Exchange the ability to establish quote width differentials greater than \$5 in unusual circumstances will have no deleterious effects on average quote widths and will contribute to the maintenance of efficient markets. The CBOE notes that this provision is consistent with ISE Rule 803(b)(4), which grants the ISE the authority to establish quote width differences other than as provided in ISE Rule 803(b)(4).

## 2. Statutory Basis

The CBOE believes that the proposed rule change is consistent with the Act<sup>10</sup> and the rules and regulations under the Act applicable to a national securities exchange and, in particular,

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<sup>10</sup> 15 U.S.C. 78a et seq.

the requirements of Section 6(b) of the Act.<sup>11</sup> Specifically, the CBOE believes that the proposed rule change is consistent with the requirements under Section 6(b)(5)<sup>12</sup> of the Act that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest.

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

The CBOE does not believe that the proposed rule change will 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

The CBOE neither solicited nor received comments on the proposal.

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

The CBOE has designated the proposed rule change as one that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date of filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. Therefore, the foregoing rule change has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>13</sup> and Rule 19b-4(f)(6) thereunder.<sup>14</sup> The CBOE has asked the Commission to waive the requirement in Rule 19b-4(f)(6)(iii)<sup>15</sup> that the CBOE provide the Commission with written notice of its intention to file the proposed rule change, along with a

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<sup>11</sup> 15 U.S.C. 78f(b).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>14</sup> 17 CFR 240.19b-4(f)(6).

<sup>15</sup> 17 CFR 240.19b-4(f)(6)(iii).



brief description and the text of the proposed rule change, at least five business days prior to filing the proposal with the Commission.

Pursuant to Rule 19b-4(f)(6)(iii) under the Act, a proposal does not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. The CBOE has asked the Commission to waive the 30-day operative delay and to allow the proposal to become operative upon filing. In this regard, the CBOE states that the proposal raises no unique issues and that it reorganizes CBOE Rule 8.7 to make clear the bid/ask differential provisions that apply in open outcry, during the opening rotation, and to classes trading on Hybrid and Hybrid 2.0. In addition, the CBOE states that new subparagraphs (i) and (ii) of CBOE Rule 8.7(b)(iv)(C) are consistent with ISE Rule 803(b)(4).

The Commission waives the five-day pre-filing requirement. In addition, the Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest because the proposed changes to CBOE Rule 8.7 are consistent with existing CBOE or ISE rules.<sup>16</sup> In this regard, current CBOE Rule 8.7(b)(iv), which applies to trading in open outcry and which will be renumbered as CBOE Rule 8.7(b)(iv)(A), provides that the bid/ask differential for in-the-money option series may be as wide as the bid/ask differential in the primary market for the underlying security. CBOE Rule 8.7(b)(iv)(A), as amended, extends this principal to in-the-money index option series by allowing the bids/ask differentials for these series to be as wide as the bid/ask differential calculated by the CBOE or its agent. Similarly, current CBOE Rule 8.7(b)(iv)(A), which will be renumbered as CBOE Rule

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<sup>16</sup> For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

8.7(b)(iv)(C), provides that the quote widths specified in current CBOE Rule 8.7(b)(iv) apply to Hybrid classes during the opening rotation. New CBOE Rule 8.7(b)(iv)(B) applies these quote widths to the opening rotation in Hybrid classes, Hybrid 2.0 classes, and Non-Hybrid and Non-Hybrid 2.0 classes. The CBOE represents that this modification makes no substantive changes to the CBOE's existing rules relating to permissible bid/ask differentials during the opening rotation.<sup>17</sup> New CBOE Rule 8.7(b)(4)(C)(i), which allows the bid/ask differential for in-the-money series trading on Hybrid and Hybrid 2.0 to be as wide as the quote width on the primary market or, for index options, as wide as the quote width calculated by the CBOE or its agent, is consistent with renumbered CBOE Rule 8.7(b)(iv)(A), as discussed above, and with current ISE Rule 803(b)(4)(i).<sup>18</sup> New CBOE Rule 8.7(b)(4)(C)(ii), allowing the CBOE to establish quote width differentials other than the \$5 width provided in CBOE Rule 8.7(b)(4)(C) for Hybrid and Hybrid 2.0 classes, is consistent with current CBOE Rule 8.7(b)(iv) and with ISE Rule 803(b)(4).<sup>19</sup> In addition, new CBOE Rule 8.7(b)(4)(C) makes clear that the \$5 bid/ask differential provided in that rule applies to both Hybrid and Hybrid 2.0 option classes. For these reasons, the Commission designates that the proposed rule change become operative as of the date of the filing of the proposal.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is

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<sup>17</sup> See also note 9, *supra*.

<sup>18</sup> ISE Rule 803(b)(4)(i) provides that the bid/ask differential for in-the-money series may be as wide as the quotation on the primary market of the underlying security.

<sup>19</sup> Current CBOE Rule 8.7(b)(iv), which applies to trading in open outcry, allows the CBOE to establish bid/ask differentials other than those provided in CBOE Rule 8.7(b)(iv) for one or more options series. Similarly, ISE Rule 803(b)(4) allows the ISE to establish bid/ask differentials other than those specified in ISE Rule 803(b)(4) for one or more options series.

necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2006-12 on the subject line.

##### Paper Comments:

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

All submissions should refer to File No. SR-CBOE-2006-12. 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 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 No. SR-CBOE-2006-12 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.<sup>20</sup>

Nancy M. Morris  
Secretary

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<sup>20</sup> 17 CFR 200.30-3(a)(12).