SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57716; File No. SR-CBOE-2007-39)

April 25, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 2 thereto, Regarding Penny Price Improvement

I.   Introduction

On April 24, 2007, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend its rules regarding price improvement for options not currently quoted in one-cent increments. The proposed rule change was published for comment in the Federal Register on May 14, 2007.[3] The Commission received two comment letters in response to the proposed rule change.[4] On March 25, 2008, the Exchange filed Amendment No. 1 to make certain modifications to the original rule filing. On March 28, 2008, the Exchange withdrew Amendment No. 1 to the proposed rule change and simultaneously filed Amendment No. 2 to the proposal. This order provides notice of the proposed rule change, as modified by Amendment No. 2, and approves the proposed rule change, as modified by Amendment No. 2, on an accelerated basis.

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[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

[3]   See Securities Exchange Act Release No. 55724 (May 8, 2007), 72 FR 27156.

[4]   See letter to Nancy Morris, Secretary, Commission, from John C. Nagel, Director & Associate General Counsel, Citadel, dated June 4, 2007 ("Citadel Letter") and letter to Nancy M. Morris, Secretary, Commission, from Michael J. Simon, Secretary, International Securities Exchange, LLC, dated June 1, 2007 ("ISE Letter").

II.   Description of the Proposal

Proposed CBOE Rule 6.13B will expand the ability of Exchange users to effect transactions in penny increments in classes and/or series trading on CBOE's Hybrid System that are not currently quoting in penny increments.[5] The Exchange will designate the classes/series eligible for this penny pricing, and the penny pricing will be available electronically and in open outcry.

As proposed, all limit orders or quotes electronically sent to CBOE (regardless of sender origin type) can be priced in a one-cent increment. Specifically, an Exchange Market-Maker can provide the Exchange with indications to trade in one-cent increments that improve on the Market-Maker's disseminated quotation. Such indications of interest will be firm for all interest received by the Exchange. Further, all other users can electronically submit orders priced in one-cent increments. The Exchange will round the limit price to the nearest permissible quoted increment for display purposes, but will maintain the one-cent increment limit price for trade execution and allocation purposes.[6] To the extent there is trading interest from multiple sources at the same one-cent increment price, priority will be established in the same manner as priority at a standard quoting increment (i.e., normal allocation procedures will be used). The Exchange

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[5]   Amendment No. 2 clarified that the program will not apply to Hybrid 3.0 classes.

[6]   For example, if the CBOE market is 1 – 1.20 and an order is received to buy 10 contracts at 1.08, CBOE would disseminate a 1.05 bid for 10 contracts, and any subsequent sell market order received by the Exchange would trade at 1.08 for up to 10 contracts (after that, the quote would revert back to 1 – 1.20).

Amendment No. 2 deletes a provision in the original filing that would have allowed the Exchange to append an indicator to the OPRA quote representing the existence of penny pricing. Additionally, in Amendment No. 2, the Exchange represents that the size and price of any penny pricing will not be displayed or made available to anyone (other than the size that is added to the Exchange's BBO to reflect the size of rounded, penny-priced orders).

has represented that the system will not execute an order at a price that would cause a trade-through of another options exchange.

With respect to open outcry, crowd members will be able to provide price improvement in one-cent increments over the Exchange's Best Bid or Offer ("BBO"). The Exchange has represented that any resulting trade will not cause a trade-through of another options exchange. Further, prior to executing any order in open outcry in a one-cent increment, Exchange members will be required to electronically "sweep" any penny pricing interest on the book that may exist.[7] The "sweep" is designed to ensure that better-priced orders resting in one-cent increments are executed prior to the open outcry transaction and that same priced orders receive executions consistent with existing rules governing priority of orders in the Hybrid book when trading with an order represented in open outcry.[8]

The Exchange represents that, in activated classes/series, all users would receive the benefit of penny pricing either through the electronic submission of contra-side orders or through a Floor Broker "sweeping" the electronic interest prior to executing an order in open outcry, and that all market participants will have the ability to rest orders in penny increments under the program.[9]

The Exchange clarified in Amendment No. 2 that, to the extent penny-priced orders are received that "cross" one another, the second order received by the system will receive the

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[7]   Open outcry penny pricing generally will be available in instances where a Floor Broker is attempting to cross an order pursuant to CBOE Rule 6.74, except it will not be available in those instances where: (i) a Floor Broker is attempting to cross orders during the opening rotation in open outcry (see CBOE Rule 6.74(c)); or (ii) a Floor Broker is utilizing the Exchange's SizeQuote Mechanism (see CBOE Rule 6.74(f)).

[8]   See CBOE Rules 6.45A(b) and 6.45B(b).

[9]   See Amendment No. 2.

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benefit of price improvement.[10] The Exchange may determine the applicability of split-price

priority under CBOE Rule 6.47 to transactions effected under proposed CBOE Rule 6.13B.[11]

The mechanics of split-price priority in those instances will be the same as the mechanics of

split-price priority in five-and ten-cent increments.

The restrictions on principal transactions and solicited orders contained in Interpretations

and Policies .01 and .02 under CBOE Rules 6.45A and 6.45B will continue to apply to trading in

penny increments, including the three second exposure requirements.

III.   Discussion and Commission Findings

After careful review of the proposal, as modified by Amendment No. 2, and the comment

letters thereto, the Commission finds that the proposal, as modified by Amendment No. 2, is

consistent with the requirements of the Act and the rules and regulations thereunder applicable to

a national securities exchange.[12] In particular, the Commission finds that the proposal is

consistent with Section 6(b)(5) of the Act,[13] which requires, among other things, that the rules of

a national securities exchange be designed to prevent fraudulent and manipulative acts and

practices, to promote just and equitable principles of trade, to remove impediments to and perfect

the mechanism of a free and open market and a national market system, and, in general, to

protect investors and the public interest.

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[10]   For example, if an order is received to buy at 1.08 and then an order is received to sell at 1.06, those orders will trade at 1.08 - the price of the resting order.

[11]   Amendment No. 2 provided that the "Exchange" will determine if the split price provisions of Rule 6.47 apply to open outcry Penny Pricing under proposed Rule 6.13B(b), rather than the "appropriate Procedure Committee," as originally proposed. The Commission notes that this change is consistent with SR-CBOE-2008-02, where the Exchange is replacing references to the "appropriate Procedure Committee" with references to the "Exchange" throughout the Exchange's rules.

[12]   In approving the proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

[13]   15 U.S.C. 78f(b)(5).

A.   Quote Rule

The Commission received two comment letters in response to the proposed rule change.[14]

One commenter argues that the proposal would violate Rule 602 of Regulation NMS (the "Quote

Rule") because CBOE will not disseminate its best bid or offer.[15] The Quote Rule requires a

national securities exchange to collect, process, and make available to vendors the best bid, the

best offer, and aggregate quotation sizes for each subject security that is communicated on any

national securities exchange by a responsible broker or dealer. A "bid" or "offer" is defined as

"the bid price or the offer price communicated by a member of a national securities exchange or

member of a national securities association to any broker or dealer, or to any customer. . . ."[16]

Because the non-displayed price of a penny-priced order under Rule 6.13B is sent to the

Exchange, but not communicated to anyone, it is not a bid, offer, or quotation. Thus, the Quote

Rule does not require this information to be disseminated.

The Quote Rule also requires responsible brokers and dealers to be firm for their

quotes.[17] Proposed CBOE Rule 6.13B(1), which allows Market Makers to provide the Exchange

with indications of interest that are superior to their own quotations in increments no smaller

than one-cent, explicitly requires such indications to be firm for all interest received by the

Exchange. Further, as with any other electronic order entered into CBOE's Hybrid System, an

order priced in a penny increment and rounded for display must be firm under CBOE's rules and

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[14]   See ISE Letter and Citadel Letter, supra note 4. Both commenters expressed concern about CBOE's proposal to append an indicator showing when there is trading interest at a price that is better than the CBOE BBO. As noted above, Amendment No. 2 deleted this aspect of the proposal. Because CBOE has proposed to eliminate the indicator, this order does not make any findings with respect to the use of an indicator.

[15]   See ISE Letter, supra note 4, at 2-3.

[16]   17 CFR 242.600(a)(8).

[17]   17 CFR 242.602(b)(2) and (c)(3).

Rule 602 of Regulation NMS.[18]

      B.   <u>Transparency, Quote Competition, and Internalization</u>

Both commenters expressed concern about the impact of penny pricing on market quality. In particular, one commenter believes such orders would undermine transparency in the options markets and that, because the prices and sizes of such orders would not be disseminated, it would be impossible for market participants to know the true best trading interest on CBOE.[19] This commenter argues that penny pricing would discourage market participants from matching or establishing a new BBO because it would be too easy for non-displayed penny orders to jump ahead of displayed orders by a penny at opportune moments.[20] Another commenter expresses a concern that no one will know the actual prices communicated to the exchange, which are prices at which transactions can take place.[21] This commenter expressed concern that if other options markets adopted similar order types, there would be a trading environment in which there would be no way for customers to make intelligent pricing decisions or for broker-dealers to fulfill their best execution obligations.[22]

Additionally, one commenter expressed the concern that hidden penny pricing will enable CBOE members to internalize their order flow without the possibility of real order interaction.

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[18]   <u>See</u> electronic mail between Angelo Evangelou, Assistant General Counsel, CBOE, and Johnna B. Dumler, Special Counsel, Division of Trading and Markets, Commission, on April 22, 2008.

[19]   <u>See</u> Citadel Letter, <u>supra</u> note 4, at 2. This commenter further believes that the concerns raised by hidden penny pricing exceed those raised by the auction facilities on other options exchanges (including the Boston Options Exchange's PIP and the International Securities Exchange's PIM) because penny pricing would be a fundamental component of options trading on CBOE rather than a separate auction facility operating parallel to the regular options market. <u>Id.</u>

[20]   <u>Id.</u>

[21]   <u>See</u> ISE Letter, <u>supra</u> note 4, at 3.

[22]   <u>Id.</u>

This commenter argues that the purpose of the requirement that a member display a customer order and wait three seconds before trading against the order is to provide other market participants with a chance to trade with the order before the member internalizes it. The commenter argues that, because only the member that enters the penny priced order will know the true price of the order, only that member can accurately run its pricing model to determine whether it is economically viable to trade against the order. The commenter does not believe this presents a level playing field.[23]

Penny priced orders will allow market participants to submit an order priced between the minimum price variation ("MPV") that will be rounded to the nearest MPV for display. Without the ability to price orders in pennies, market participants would not be able to submit orders priced between the MPV. Instead, orders, if submitted, would be priced (and displayed) at the MPV. Thus, CBOE's proposal will not "take away" transparency that would already exist. The Commission recognizes that under CBOE's proposal, orders will not be displayed at their actual penny price. CBOE's proposal, however, will provide investors with the opportunity to trade at a better price than would otherwise be available. The Commission believes that this opportunity for investors to receive executions inside the disseminated best bid or offer could result in better executions for investors.

In response to a commenter's concern about broker-dealers' ability to fulfill their best execution obligations,[24] as just discussed, the Commission believes that penny-priced orders likely will provide another opportunity for investors to receive executions inside the disseminated best bid or offer for a security, which could result in better executions for investors. The availability of this price improvement feature will be a factor to be considered in a broker-

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[23]   Id.

[24]   See ISE Letter, supra note 4, at 2.

dealer's best execution routing determination, similar to other factors a broker-dealer must consider in connection with its best execution obligation.[25]

The Commission also believes that penny-priced orders will provide market participants with an additional tool to submit trading interest to the Exchange. The ability to price orders in penny increments may serve to increase liquidity to the extent that market participants find it to be useful and result in better executions. Further, market participants may be incented to compete by putting forth their best price -- priced in a penny increment -- to potentially match or better any other penny-priced orders resident in the System. This may result in more aggressive, rather than less aggressive, trading interest.

Moreover, the Commission believes that the ability to "fish" inside the displayed quote, coupled with the restriction on the market participant that initially submitted the penny-priced order from trading with that order until after three seconds has elapsed, will provide a meaningful opportunity for interaction prior to the time at which the submitting market participant can interact with the order. The Commission also notes that a market participant that would like to trade against its customer order runs the risk that the customer order, if entered in a hidden penny increment, will execute against another penny-priced order resident in the system. The Commission does not believe that the availability and use of penny-priced orders will reduce the quality or competitiveness of the options markets by increasing the level of internalization in the options markets.

C. Linkage Plan

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[25] See Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (order approving SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080), at notes 130 to 134 and accompanying text.

One commenter expresses concern as to how hidden penny-priced orders will interact with the requirements of the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage ("Linkage Plan").[26] Specifically, the commenter expresses concern that, because the existence of hidden penny orders would not be disseminated to the market, they would not trigger the obligations of other market centers to ship linkage orders to the CBOE.[27] Therefore, the commenter believes that away-markets will not be able to benefit from the better prices available on the CBOE, and undisplayed orders resting on the CBOE book would not be protected from trade-throughs by away markets.[28]

The Linkage Plan, and SRO rules adopted pursuant to the Plan, provide trade through protection to the national best bid and offer ("NBBO").[29] The NBBO will not include the non-displayed price of a CBOE penny-priced order under Rule 6.13B. Therefore, the non-displayed price of a penny-priced order is not subject to trade through protection under the Linkage Plan.

D.   Penny Pilot Program

One commenter believes that the proposal will circumvent the industry efforts with respect to the Penny Pilot Program ("Pilot") by moving to hidden penny quoting without the benefit of careful study of the data yielded in the Pilot.[30] Another commenter believes that the appropriate way to address penny pricing in options is through the current Penny Pilot. This commenter recommends that the Commission consider any expansion of penny quoting only

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[26]   See Citadel Letter, supra note 4, at 2.

[27]   See Citadel Letter, supra note 4, at 2.

[28]   Id.

[29]   The national best bid or offer is defined in the Linkage Plan as the national best bid and offer in an options series calculated by a Participant. See Section 2(19) of the Linkage Plan.

[30]   See Citadel Letter, supra note 4, at 1 and 3.

through review of the experience under the Pilot.[31] As discussed above, the Commission finds

that CBOE's proposal, as amended, is consistent with the Act. The Commission has previously

approved proposals by options exchanges, including CBOE, to trade in penny increments.[32] The

Commission does not believe it is appropriate to prohibit CBOE from implementing an initiative

designed to allow further limited trading, not quoting, in penny increments.

The Commission finds good cause to approve the proposed rule change, as modified by

Amendment No. 2, prior to the thirtieth day after the date of publication of the notice of filing of

the amended proposal in the Federal Register. The substance of the proposed rule change was

published in the Federal Register on May 14, 2007 for full notice and comment.[33] The

Commission believes that the changes proposed in Amendment No. 2 respond to concerns raised

in the commenter letters and strengthen and clarify aspects of the proposal. Further, the

Commission recently approved a similar proposal by another exchange that allows orders to be

entered in one-cent increments, but displayed at the standard MPV.[34] For these reasons, the

Commission finds good cause for approving the proposed rule change, as modified by

Amendment No. 2, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.

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[31] See ISE Letter, supra note 4, at 3.

[32] See, e.g., Securities Exchange Act Release Nos. 54229 (July 27, 2006), 71 FR 44508 August 3, 2006) (File No. SR-CBOE-2005-90) (order approving CBOE's Simple Auction Liaison system); 50819 (December 8, 2004), 69 FR 75093 (December 15, 2004) File No. SR-ISE-2003-06) (order approving ISE's Price Improvement Mechanism); and 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving BOX's Price Improvement Period).

[33] See supra note 3.

[34] See Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (order approving SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080).

IV.   Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning

Amendment No. 2, including whether Amendment No. 2 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 No. SR-CBOE-2007-39
  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-2007-39. 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 at 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, 100 F Street,

NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00

p.m. 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-

2007-39 and should be submitted on or before [insert date 21 days from publication in the

<u>Federal</u> <u>Register</u>].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[35] that the proposed rule change (SR-CBOE-2007-39), as modified by Amendment No. 2, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[36]

Florence E. Harmon
Deputy Secretary

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[35] 15 U.S.C. 78s(b)(2).

[36] 17 CFR 200.30-3(a)(12).