

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57610; File No. SR-CBOE-2008-14)

April 3, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change to Establish a Solicitation Auction Mechanism and to Amend its Automated Improvement Mechanism

I. Introduction

On February 7, 2008, 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”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to establish a new automated mechanism for auctioning larger-sized orders and to modify its existing automated improvement mechanism (“AIM”) to permit its use for the execution of complex orders. The proposed rule change was published for comment in the Federal Register on February 28, 2008.<sup>3</sup> The Commission received no comments regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

Under CBOE Rules 6.45A, Priority and Allocation of Equity Option Trades on the CBOE Hybrid System, and 6.45B, Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System, order entry firms that electronically enter orders are required to expose an unsolicited agency order (“Agency Order”) for at least 3 seconds before crossing it against an order that it has solicited from other broker-dealers.<sup>4</sup> Currently, an order entry firm can comply with this requirement by entering the Agency Order on the

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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> See Securities Exchange Act Release No. 57357 (February 20, 2008), 73 FR 10837.

<sup>4</sup> See CBOE Rule 6.45A.02 and 6.45B.02.

Exchange, waiting 3 seconds, and then entering the solicited order. According to the Exchange, because of the 3-second exposure requirement, order entry firms have no level of assurance that they will be able to electronically pair solicited orders against Agency Orders for executions. As an alternative, CBOE has developed AIM, which permits an Agency Order to be electronically executed against principal or solicited interest.<sup>5</sup>

CBOE has also developed an enhanced auction mechanism for larger-sized simple and complex Agency Orders that are to be executed against solicited orders (the “Auction”). The proposal would implement this functionality in options classes designated by the Exchange. Such orders would be required to be for at least 500 contracts, must be entered as all-or-none limit (“AON”) orders,<sup>6</sup> and would be executed only if the price is at or better than the CBOE best bid or offer (“BBO”).

When a proposed solicited cross is entered into the Auction, the Exchange would send a Request for Responses (“RFR”) message to all members that have elected to receive such messages. Members would then have 3 seconds to respond with a price that would improve the proposed execution price for the Agency Order, except that responses would not be entered for the account of an options market maker from another options exchange. Responses may be entered and executed at prices that are in a multiple of the applicable minimum price increment that has been designated by the Exchange for the series, which increment may not be less than

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<sup>5</sup> See CBOE Rule 6.74A, Automated Improvement Mechanism (“AIM”).

<sup>6</sup> The Exchange’s existing rules provide that an AON order may be crossed with another AON order if all bids or offers at the same price at which the cross is to be effected have been filled. See, e.g., Interpretation and Policy .01 to CBOE Rule 6.44, Bids and Offers in Relation to Units of Trading. The proposed Auction system is modeled after this principle, except that it would allow the crossing of large-sized AON orders to take place so long as there are no public customer orders at the proposed price and there is insufficient size at an improved price to accommodate the Agency Order.

\$0.01. The Exchange believes this would allow for greater flexibility in pricing large-sized orders and provide for a greater opportunity for price improvement.

The Auction will conclude at the sooner of various conditions.<sup>7</sup> At the conclusion of the Auction, the Agency Order would be executed against the solicited order unless there is sufficient size to execute the entire Agency Order at a price (or prices) that improves the proposed crossing price. In the case where there is one or more public customer orders resting in the book at the proposed execution price on the opposite side of the Agency Order, the solicited order would be cancelled and the Agency Order would be executed against other bids (offers) if there is sufficient size at the bid (offer) to execute the entire size of the Agency Order (size would be measured considering resting orders and quotes and responses).<sup>8</sup> If there is not sufficient size to execute the entire Agency Order, the proposed cross would not be executed and both the Agency Order and solicited order would be cancelled. Additionally, the proposed cross would not be executed and both the Agency Order and solicited order would be cancelled if the execution price would be inferior to the BBO.

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<sup>7</sup> The Auction shall conclude at the sooner of: (i) the end of the response period, (ii) upon receipt by the Hybrid Trading System (“Hybrid”) of an unrelated order (in the same series as the Agency Order) that is marketable against either the Exchange’s disseminated quote (when such quote is the NBBO) or the responses, (iii) upon receipt by Hybrid of an unrelated limit order (in the same series as the Agency Order and on the opposite side of the market as the Agency Order) that improves any response, (iv) any time a response matches the Exchange’s disseminated quote on the opposite side of the market from the responses, or (v) any time there is a quote lock on the Exchange pursuant to CBOE Rule 6.45A(d) or 6.45B(d). See paragraph (b)(2) of proposed CBOE Rule 6.74B, Solicitation Auction Mechanism.

<sup>8</sup> When the Agency Order is executed at an improved price(s) or at the proposed execution price against electronic orders, quotes and responses, priority would be pursuant to the allocation algorithm in effect pursuant to CBOE Rule 6.45A or 6.45B, as applicable. The allocation for simple and complex orders would be the same, except that complex orders would also be subject to the complex order priority rules applicable to bids and offers in the individual series legs of a complex order contained in paragraphs (d) or .06 of CBOE Rule 6.53C, Complex Orders on the Hybrid System, as applicable.

The proposed rule would also require members to deliver to customers a written document, in a form approved by the Exchange, describing the terms and conditions of the Auction mechanism prior to executing Agency Orders using the Auction mechanism.

The proposed rule would also specify that members may not use the Auction mechanism to circumvent the Exchange's rules limiting principal order transactions.<sup>9</sup> Additionally, the Exchange notes that for purposes of paragraph (e) to CBOE Rule 6.9, Solicited Transactions, which paragraph prohibits anticipatory hedging activities prior to the entry of an order on the Exchange, the terms of an order would be considered "disclosed" to the trading crowd on the Exchange when the order is entered into the Auction mechanism.

Finally, the Exchange is proposing to expand its existing AIM auction, which currently only applies to simple orders, to cover complex orders. Accordingly, complex orders would be eligible for execution through AIM at a net debit or net credit price provided the Auction eligibility requirements of the AIM rule are satisfied and the Agency Order is eligible for AIM considering its complex order type, order origin code (i.e., non-broker-dealer public customer, broker-dealers that are not Market-Makers or specialists on an options exchange, and/or Market-Makers or specialists on an options exchange), class, and marketability as determined by the Exchange. Allocation of complex orders that are subject to AIM will be the same as the existing allocation procedures, provided that the complex order priority rules applicable to bids and offers in the individual series legs of a complex order contained in CBOE Rule 6.53C(d) or 6.53C.06, as applicable, will continue to apply. In addition, the Exchange is proposing to provide in its rules that it may determine on a class-by-class basis that orders of 500 or more contracts may be

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<sup>9</sup> See CBOE Rules 6.45A.01, 6.45B.01, 6.74, Crossing Orders, and 6.74A.

executed through AIM without considering prices that might be available on other options exchanges. All other aspects of the AIM auction will continue to apply unchanged.

### III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>10</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>11</sup> 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. The Commission believes that the proposal should allow for greater flexibility in pricing large-sized orders and may provide a greater opportunity for price improvement. The Commission also notes that the proposal is substantially similar to requirements set forth in the rules of another exchange.<sup>12</sup>

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<sup>10</sup> 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).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> See paragraphs (d) and (e) of ISE Rule 716.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>13</sup> that the proposed rule change (SR-CBOE-2008-14), be, and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>14</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>13</sup> 15 U.S.C. 78s(b)(2).

<sup>14</sup> 17 CFR 200.30-3(a)(12).