

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-58422; File No. SR-CBOE-2008-89

August 25, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend its Rules Related to the Hybrid 3.0 Platform and Lead Market-Makers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 22, 2008, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I and II, which Items have been prepared by the Exchange. The Exchange filed the proposal as a “non-controversial” proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act³ and Rule 19b-4(f)(6) thereunder.⁴ 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 Exchange proposes to amend its rules relating to the Hybrid 3.0 Platform (“Hybrid 3.0”) and Lead Market-Makers (“LMMs”). The text of the proposed rule change is available on the Exchange’s Web site (www.cboe.org/Legal), at the Exchange’s Office of the Secretary and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A)(iii).

⁴ 17 CFR 240.19b-4(f)(6).

In its filing with the Commission, the self-regulatory organization 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 those 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 parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing various changes related to Hybrid 3.0 and LMMs. First, Hybrid 3.0 is an electronic trading platform on CBOE's Hybrid Trading System ("Hybrid") that allows a single quoter to submit an electronic quote that represents the aggregate Market-Maker quoting interest in a series for the trading crowd. CBOE is proposing to amend its rules to permit one or more quoters to submit electronic quotes in Hybrid 3.0 classes. The quotes would continue to represent the aggregate Market-Maker quoting interest in a series for the trading crowd. In particular, for example, if there are two LMMs appointed to submit electronic quotes at the same time in a particular series of a Hybrid 3.0 class, the following would apply:

- The best bid and best offer quote would be determined by considering all quotes available. For example, if LMM1 submits a quote of \$1 - \$1.20 for 100 contracts and LMM2 submits a quote of \$0.95 - \$1.10 for 50 contracts, the best bid and offer quote would be \$1 - \$1.10, 100 X 50, which represents a firm disseminated market quote that the trading crowd is responsible for on an aggregate basis.
- The size of multiple quotes at the same price would be aggregated. For example,

if LMM1 submits a quote of \$1 - \$1.10 for 100 contracts and LMM2 submits a quote of \$0.95 - \$1.10 for 50 contracts, the best bid and best offer quote would be \$1 - \$1.10, 100 X 150, which represents a firm disseminated market quote that the trading crowd is responsible for on an aggregate basis.

The Exchange believes having the flexibility to have more than one quoter submit electronic quotes would help the Exchange to maintain a fair and orderly market, including in those instances where a quoter may be experiencing system problems and back-up quotes are needed. The Exchange also believes the proposal is consistent with other provisions in our rules that permit the Exchange to appoint more than one market-maker in good standing to determine a formula for generating automatically updated market quotations for a given class using the Exchange's AutoQuote system or a proprietary automated quotation updating system.⁵

Second, consistent with the existing Hybrid 3.0 Platform, automatic execution against Market-Maker quotes would not be allowed. Thus, for example, quotes would not automatically execute against other quotes. In this regard, the Exchange is proposing to amend Rule 6.45B(d) to resolve an inconsistency in its rules and make clear what would happen in the scenario where two quotes lock the market in a Hybrid 3.0 class. In particular, though the Exchange's rules elsewhere indicate that there will not be automatic execution

⁵ See Rules 8.7.07, Additional Obligations for Classes in Which CBOE Hybrid System is NOT Implemented, and 8.15, Lead Market-Makers and Supplemental Market-Makers in Non-Hybrid and Hybrid 3.0 Classes. The Exchange is also proposing to amend the title of Rule 8.15 to delete an outdated reference to "Non-Hybrid" since there are not any of these classes. See Securities Exchange Act Release No. 58153 (July 14, 2008), 73 FR 41386 (July 18, 2008)(SR-CBOE-2008-67) (immediately effective rule change that, among other things, deleted references to "Non-Hybrid" classes in the CBOE Rules).

against quotes,⁶ Rule 6.45B(d) currently indicates that there will be up to a ten second counting period before locked quotes automatically execute against each other. To resolve this inconsistency, the Exchange is proposing to amend Rule 6.45B(d) to provide that, in the event a Market-Maker's disseminated quote(s) in a Hybrid 3.0 class would interact with the disseminated quote(s) of another Market-Maker resulting in a "locked" quote (e.g., \$1.00 bid - \$1.00 offer), then (i) the Exchange will disseminate the locked market and both quotes will be deemed "firm" disseminated market quotes; (ii) the Market-Maker(s) whose quotes are locked will receive a quote update notification advising that their quotes are locked; and (iii) the locked quotes will not automatically execute against each other – instead they will remain locked until a quote is cancelled or changed.

Third, CBOE has an Off-Floor LMM program that provides LMMs with the flexibility to operate remotely away from CBOE's trading floor. CBOE is proposing to expand the program, which is currently limited to Hybrid classes,⁷ to include Hybrid 3.0 classes. Specifically, CBOE proposes to amend Rule 8.15 to provide that an LMM will generally operate on CBOE's trading floor (referred to as an "On-Floor LMM"), but can request that the Exchange authorize the LMM to function remotely away from CBOE's

⁶ See paragraph (b)(i)(A)(2) of Rule 6.13, CBOE Hybrid System's Automatic Execution Feature (which indicates only that eligible orders will receive automatic execution against public customer orders in the electronic book); see also Securities Exchange Act Release No. 55874 (June 7, 2007), 72 FR 32688 (June 13, 2007)(SR-CBOE-2006-101)(order approving the Hybrid 3.0 Platform which indicates, among other things, that automatic execution against quotes (whether electronic or manual) will not be allowed).

⁷ See Securities Exchange Act Release No. 57747 (April 30, 2007 [sic]), 73 FR 25811 (May 7, 2008)(SR-CBOE-2008-49)(immediately effective rule change adopting the Off-Floor LMM program for Hybrid classes).

trading floor (referred to as an “Off-Floor LMM”) on a class-by-class basis for Hybrid 3.0 classes. The procedures for Off-Floor LMMs in Hybrid 3.0 classes will be substantially the same as the procedures that are applicable to Off-Floor LMMs in Hybrid classes.⁸ The procedures will provide the following:

- An LMM can request that the Exchange authorize it to operate as an Off-Floor LMM in one or more classes. The Exchange will consider the factors specified in Rule 8.15(a)(1),⁹ as well as the factors applicable to Off-Floor DPMs specified in paragraph (g) of Rule 8.83, Approval to Act as a DPM,¹⁰ in determining whether to

⁸ See Interpretation and Policy .01 to Rule 8.15A, Lead Market-Makers in Hybrid Classes.

⁹ Rule 8.15(a)(1) provides that the factors to be considered in selecting LMMs in Hybrid 3.0 classes include: adequacy of capital, experience in trading index options or options on ETFs, presence in the trading crowd, adherence to Exchange rules and ability to meet the obligations specified below. An individual may be appointed as an LMM in only one zone for an expiration month but may also be appointed as a Supplemental Market-Maker (“SMM”) in other zones. When individual members are associated with one or more other members, only one member may receive an LMM appointment.

¹⁰ In addition to CBOE’s Off-Floor LMM program, CBOE also has an Off-Floor DPM program. Rule 8.83(g) provides that the factors to be consider in determining whether to permit a Designated Primary Market-Maker (“DPM”) to operate as an Off-Floor DPM include, but are not limited to, any one or more of the following: (i) adequacy of capital; (ii) operational capacity; (iii) trading experience of and observance of generally accepted standards of conduct by the applicant, its associated persons, and the DPM Designees who will represent the applicant in its capacity as a DPM; (iv) number and experience of support personnel of the applicant who will be performing functions related to the applicant’s DPM business; (v) regulatory history of and history of adherence to CBOE Rules by the applicant, its associated persons, and the DPM Designees who will represent the applicant in its capacity as a DPM; (vi) willingness and ability of the applicant to promote the Exchange as a marketplace; (vii) performance evaluations conducted pursuant to Rule 8.60, Evaluation of Trading Crowd Performance; and (viii) in the event that one or more shareholders, directors, officers, partners, managers, members, DPM Designees, or other principals of an applicant is or has previously been a shareholder, director, officer, partner, manager, member, DPM Designee, or other principal in another DPM, adherence by such DPM to the requirements set forth in Section C of Chapter VIII of the CBOE Rules respecting DPM responsibilities and obligations during the

permit an LMM to operate as an Off-Floor LMM. If an LMM is approved to operate as an Off-Floor LMM in one or more classes, the Off-Floor LMM can have an LMM designee trade in open outcry in the option classes allocated to the Off-Floor LMM, but the Off-Floor LMM shall not receive a participation entitlement under Rule 8.15B, Participation Entitlement of LMMs, with respect to orders represented in open outcry.

- An LMM that is approved to operate as an Off-Floor LMM in one or more classes can request that the Exchange authorize it to operate as an On-Floor LMM in those option classes. In making such a determination, the Exchange should evaluate whether the change is in the best interests of the Exchange, and may consider any information that it believes will be of assistance to it. Factors to be considered may include, but are not limited to, performance, operational capacity of the Exchange or LMM, efficiency, number and experience of personnel of the LMM who will be performing functions related to the trading of the applicable securities, number of securities involved, number of Market-Makers affected, and trading volume of the securities.¹¹
- In addition, CBOE is proposing to include a requirement that, as part of a pilot program until March 14, 2009, an Off-Floor LMM not allow more than one Market-Maker affiliated with the Off-Floor LMM to trade on CBOE's trading floor in any specific option class allocated to the Off-Floor LMM and provided such Market-

time period in which such person(s) held such position(s) with the DPM.

¹¹ These On-/Off-Floor LMM provisions are substantially similar to the corresponding provisions for On-/Off-Floor Hybrid LMMs in paragraph .01(b) to Rule 8.15A and for On-/Off-Floor DPMs in paragraphs (g) and .01 to Rule 8.83.

Maker is trading on a separate membership (absent the pilot program, an Off-Floor LMM may not allow any Market-Makers affiliated with the Off-Floor LMM to trade on CBOE's trading floor in any class allocated to the Off-Floor LMM) and provided the Off-Floor LMM does not have an LMM designee trading in open outcry in the option classes allocated to the Off-Floor LMM.¹²

By permitting an LMM appointed to a Hybrid 3.0 class to function as an Off-Floor LMM, CBOE believes that the rule change provides more flexibility to a member organization that may wish to function remotely, and provides more flexibility to CBOE when allocating option classes to the best applicant. It also removes a potential operational dilemma for a Market-Maker that functions as a DPM or LMM in other Hybrid classes and would like to function remotely away from the trading floor as a DPM/LMM in all of its option classes. Accordingly, CBOE believes that the proposed rule change is designed to promote just and equitable principles of trade.

Fourth, CBOE is proposing to update the LMM obligations listed in Rule 8.15 to include a requirement that, subject to paragraph (d) of Rule 54.7, General Prohibitions (under the CBOE Stock Exchange Rules), LMMs in Hybrid 3.0 classes (whether On-Floor or Off-Floor) maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the LMM or act as specialist or Market-Maker in any security

¹² This provision is substantially similar to existing provisions in CBOE's rules respecting Off-Floor Hybrid LMMs and Off-Floor DPM obligations. See paragraph .01(c) of CBOE Rule 8.15A and paragraph (a)(v) of CBOE Rule 8.85, DPM Obligations. CBOE is proposing a related cross-reference update to paragraph (c)(vii)(1) of CBOE Rule 8.3.

underlying options allocated to the LMM, and otherwise comply with the requirements of Rule 4.18, Prevention of the Misuse of Material, Non-Public Information.¹³

Finally, CBOE is proposing to amend Rule 8.15B. Currently under the rule, if an LMM entitlement has been established for a class, the entitlement applies for both electronic and open outcry trades (except that, as discussed above, an Off-Floor LMM is not eligible to have an open outcry participation entitlement). The Exchange is proposing to amend the rule to provide that an LMM participation entitlement may be established for electronic and/or open outcry trading on a class-by-class basis (except that an Off-Floor LMM would still not be eligible to have an open outcry participation entitlement). This change would apply for Hybrid and Hybrid 3.0 classes. The change will provide the Exchange with flexibility to determine, for example, to have a participation entitlement for electronic trades executed by an LMM(s) in Hybrid options class XYZ but have no participation entitlement for trades executed in open outcry by an LMM(s) in the same class.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.¹⁴ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5) Act¹⁵ requirements 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.

¹³ This language is substantially similar to existing language in CBOE's rules respecting Hybrid LMM obligations and e-DPM obligations. See paragraph (b)(vii) of Rule 8.15A and paragraph (x) of Rule 8.93, e-DPM Obligations.

¹⁴ 15 U.S.C. 78f(b).

¹⁵ 15 U.S.C. 78f(b)(5).

The Exchange believes that the proposed changes to allow for more than one quoter to submit electronic quotes in Hybrid 3.0 classes, to clarify the manner in which the Hybrid 3.0 Platform operates in a locked market scenario, to allow for Off-Floor Hybrid 3.0 LMMs and update our information barrier procedures for LMMs generally, and to allow for the application of an LMM participation entitlement for electronic and/or open outcry trades should help the Exchange to maintain a fair and orderly market and create incentives for LMMs to provide liquidity, and investors will benefit as a result.

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

CBOE does not believe that the proposed rule change will impose any burden on competition 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 Exchange neither solicited nor received comments on the proposal.

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

Because the foregoing rule does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change or such shorter time as designated by the Commission, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁶ and Rule 19b-

¹⁶ 15 U.S.C. 78s(b)(3)(A).

4(f)(6) thereunder.¹⁷ At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is 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. Please include File Number SR-CBOE-2008-89 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2008-89. 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,

¹⁷ 17 CFR 240.19b-4(f)(6).

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 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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-2008-89 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Florence E. Harmon
Acting Secretary

¹⁸ 17 CFR 200.30-3(a)(12).