

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-56680; File No. SR-CBOE-2007-59)

October 19, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change to Amend the Minimum Quote Size Requirements for Hybrid Opening System Rotations

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 September 17, 2007, 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, II, and III below, which Items have been substantially prepared by the Exchange. 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 minimum quote size requirements that are applicable to trading rotations conducted via the Hybrid Opening System (“HOSS”). The text of the proposed rule change is available at the Exchange, on the Exchange’s Web site ([www.cboe.org/Legal](http://www.cboe.org/Legal)), 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

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

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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 Exchange proposes to amend CBOE Rule 6.2B, Hybrid Opening System ("HOSS"), which pertains to trading rotations for series trading on the CBOE Hybrid Trading System ("Hybrid"), in order to modify the minimum quote size requirements applicable to Market-Makers, Remote Market-Makers, Designated Primary Market-Makers, Electronic Designated Primary Market-Makers and Lead Market-Makers (collectively referred to as "Market-Makers").<sup>3</sup>

With respect to Market-Makers' quote sizes generally, CBOE Rule 8.7 ("Obligations of Market-Makers") currently provides that the initial size a Market-Maker electronically quotes must be at least ten contracts (undecrement size) (the "10-up" requirement); however, if the underlying primary market disseminates a 100-share best bid or offer quote (which is the equivalent of one option contract), a Market-Maker's

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<sup>3</sup> Currently, Designated Primary Market-Makers, Electronic Designated Primary Market-Makers and Lead Market-Makers are required to enter opening quotes in accordance with CBOE Rule 6.2B in 100% of the series of each appointed class; whereas, other Market-Makers and Remote Market-Makers are permitted, but not required, to enter opening quotes in accordance with CBOE Rule 6.2B. See CBOE Rules 6.2B, 8.15A ("Lead Market-Makers in Hybrid Classes") (subparagraph (b)(iv) of this rule has been interpreted by the Exchange to require an LMM to enter opening quotes in 100% of the series of each appointed class), 8.85 ("DPM Obligations"), and 8.93 ("e-DPM Obligations"). The Exchange notes, however, that it has submitted a separate proposed rule change that would modify the opening quote obligations of Designated Primary Market-Makers, Electronic Primary Market-Makers, and Lead Market-Makers. See SR-CBOE-2007-87.

undecremented quote may be for as low as one contract (“1-up”).<sup>4</sup> The proposed revisions to CBOE Rule 6.2B would revise these parameters only with respect to opening rotations in Hybrid classes. In particular, the existing minimum quote size requirements would continue to apply, except that a Market-Maker would be permitted to enter an opening quote for as low as one contract if the underlying primary market disseminates less than a 1000-share best bid or offer quote (which is the equivalent of ten contracts) immediately prior to an option series opening.<sup>5</sup>

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<sup>4</sup> See, e.g., CBOE Rule 8.7(d)(ii)(B).

<sup>5</sup> Under CBOE Rule 6.2B, the HOSS rotation process for an option class is initiated when the underlying market opens. When the underlying market “opens” is determined, on a class-by-class basis, to be either the opening trade and/or opening quote (or whichever occurs first). In addition, the Commission notes that CBOE recently modified the parameters for determining when the underlying market opens. See Securities Exchange Act Release No. 56600 (October 2, 2007), 72 FR 57619 (October 10, 2007) (SR-CBOE-2007-88). Once the underlying market open occurs, HOSS initiates the overlying option class opening and sends a Rotation Notice to market participants. Thereafter, HOSS will open the series of a class in a random order. The Exchange notes that the underlying primary market’s last reported quotation information may change between the time that the underlying market opens and the time that an overlying option series opens. For purposes of the proposed “1-up” quoting relief, the Exchange proposes that a Market-Maker only look to the underlying primary market’s last reported quotation information that exists immediately prior to time the Market-Maker enters its opening quotes. Thus, for example, if an underlying primary market has “opened” with a best bid of 1000 shares and best offer of 1000 shares and, subsequent to that time but immediately prior to the time the Market-Maker enters its opening quotes, the underlying primary market’s last reported best bid was 500 shares and best offer was 500 shares (i.e., 500x500), a Market-Maker would be permitted to enter a minimum opening quote for one contract on both the bid and offer sides of a call or put series (i.e., 1x1). If, however, the underlying primary market’s best bid was 500 shares and best offer was 1000 shares immediately prior to the time the Market-Maker enters its opening quotes (i.e., 500x1000), to the extent required to quote, a Market-Maker would be permitted to enter a minimum opening quote for one contract on the bid side and required to enter a minimum opening quote for ten contracts on the offer side for a call series (i.e., 1x10). Similarly, to the extent required to quote, a Market-Maker would be required to enter a minimum opening quote for ten contracts on the bid side and permitted to enter a minimum opening quote for one contract on

Generally, the Exchange believes that the existing quote size requirement imposes a reasonable obligation on Market-Makers, who, in turn for satisfying this and other obligations, are entitled to receive market maker margin treatment. Nevertheless, the Exchange believes that there are instances where requiring Market-Makers to quote 10-up during an opening rotations imposes a heightened and inappropriate level of risk upon them. Accordingly, in the Exchange's view, the purpose of this filing is to adopt a limited exception to the 10-up minimum quoting requirement to provide relief in one such specific instance.

The Exchange believes that, when the underlying primary market disseminates less than a 1000-share quote, it substantially restricts the amount of liquidity available in that security on that particular side of the market. The Exchange notes that options exchanges are derivative markets. In this regard, the Exchange believes that, with a minimum quote size requirement of ten contracts over multiple series, an options

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the offer side for a put series (i.e., 10x1). This ability to enter an opening quote for as low as one contract under CBOE Rule 6.2B would take precedence over any other Exchange rules regarding initial size. See proposed CBOE Rule 6.2B.02. In this regard, the Exchange notes that, as compared to the intra-day quoting requirements in CBOE Rule 8.7, there would be no requirement that the opening quote process be automated and the Market-Maker's quote size automatically return to at least 10-up when the underlying primary market no longer disseminates less than a 1000-share quote. Instead, once a 1-up opening quote is entered by a Market-Maker, the Market-Maker may maintain the quote until it is decremented or the Market-Maker determines to update it. Once an option series is opened and a Market-Maker's quote is decremented or the Market-Maker determines to update the quote, such updated quote would be subject to the electronic quotation size obligations set forth in CBOE Rule 8.7, which as discussed above requires that the initial size a Market-Maker electronically quotes must be at least ten contracts (undecrement size). For intra-day quoting, CBOE Rule 8.7 also provides that, if the underlying primary market disseminates a 100-share quote, a Market-Maker's undecrement quote may be for as low as one contract, provided the process is automated and the quote automatically returns to at least 10-up when the underlying primary market no longer disseminates a 100-share quote. See supra, note 4.

exchange provides exponentially more liquidity than is available in an underlying primary stock market that is disseminating less than a 1000-share quote.<sup>6</sup> Additionally, according to the Exchange, Market-Makers must hedge their transactions by buying and/or selling stock, and when the underlying primary stock exchange posts less than a 1000-share quote during the opening, it restricts the Market-Maker's ability to hedge, which does nothing but increase the Market-Maker's financial exposure and risk. This exposure and risk is intensified during the opening, which tends to be one of the busiest periods of the trading day. For these reasons, the Exchange believes that Market-Makers in this instance should have the ability to lower their Hybrid opening quote sizes to as low as one contract if they choose, thereby being more consistent with the amount of liquidity provided by the underlying primary market.<sup>7</sup>

The Exchange states that it is also cognizant of the desire to continue to maintain fair and orderly openings. CBOE does not think that this proposal would detract from that objective because, irrespective of the size associated with a Market-Maker's quotes, the options class would continue to open in the same automated fashion and, to the extent

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<sup>6</sup> According to the Exchange, an options exchange may list 20 or more options series for an underlying stock. Thus, for example, if just a single Maker-Maker posts 10-up markets in twenty series, that Market-Maker alone would be providing liquidity equivalent to 20,000 shares, which would dwarf the underlying primary market's size commitment of less than 1000 shares.

<sup>7</sup> The Exchange also believes that nothing in this proposal would affect a Market-Maker's obligation to honor its firm quote requirements imposed by CBOE Rule 8.51 ("Firm Disseminated Market Quotes"). Accordingly, for example, if a Market-Maker disseminates a one contract market, its firm quote obligation would be one contract.

there may be any market order imbalance on the opening, such imbalances would continue to be addressed in the same manner.<sup>8</sup>

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,<sup>9</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>10</sup> in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest. The Exchange believes that the proposal provides for a very limited exception to the general requirement that Market-Maker's quotes be for a minimum ten contracts. The Exchange believes that this exception, which

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<sup>8</sup> HOSS will not open an option series if the opening trade would leave a market order imbalance (*i.e.*, there are more market orders to buy or to sell for the particular series than can be satisfied by the limit orders, quotes and market orders on the opposite side). If this condition occurs, a notification will be sent to market participants indicating the size and direction (buy or sell) of the market order imbalance. HOSS will not open the series until the market order imbalance is satisfied and will repeat this process until the series is open. See CBOE Rule 6.2B(e)(iii) and (f). Upon receipt of these messages, generally the Designated Primary Market-Maker and Electronic Designated Primary Market-Maker(s) or Lead Market-Maker, as applicable, other Market-Makers with an appointment in the class, and/or other market participants, would take steps to address and resolve the market order imbalance (which steps may include, for example, a Market-Maker adding more size to his quotes). See also CBOE Rule 8.7(b) (which provides, among other things, that 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 temporary disparity between the supply of and demand for a particular option contract) and CBOE Rule 7.5 (“Obligation for Fair and Orderly Market”) (which provides, among other things, that Market-Makers with an appointment in a class that are present on the floor of the Exchange may be called upon to make bids and/or offers that contribute to meeting the standards set forth in CBOE Rule 8.7).

<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

in the Exchange's view is narrowly-tailored, will provide a measure of protection to Marker-Makers when the underlying primary market disseminates less than a 1000-share quote during the opening. Accordingly, the Exchange believes the proposal serves to enhance the incentives of Market-Makers to quote competitively during Hybrid opening rotations and reduces the disincentives to quote competitively.

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

The Exchange 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

No written comments were solicited or received 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, or
- B. institute proceedings to determine whether the proposed rule change 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 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-2007-59 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 Number SR-CBOE-2007-59. 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 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 Number SR-CBOE-2007-59 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>11</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>11</sup> 17 CFR 200.30-3(a)(12).