SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58296; File No. SR-CBOE-2008-30)

August 4, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change Relating to the Hybrid Opening System

I. Introduction

On June 5, 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")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to revise its Hybrid Opening System ("HOSS") procedures to allow the Hybrid Agency Liaison ("HAL") functionality to be available on the openings in designated classes. The proposed rule change was published for comment in the Federal Register on June 30, 2008.[3] The Commission received no comments regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposal

CBOE Rule 6.2B, "Hybrid Opening System ("HOSS")," sets forth procedures for opening trading rotations for series trading on the CBOE Hybrid Trading System ("Hybrid"). The current HOSS method for opening chooses a single "market clearing" price that will leave unexecuted those bids and offers that cannot trade with each other.[4] However, one or more series of a class may not open if one of the following conditions is met: (1) no opening quote

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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. 57997 (June 20, 2008), 73 FR 36939.

4 In determining the priority of orders and quotes to be traded, HOSS gives priority to market orders first, then to limit orders and quotes whose price is better than the opening price, and then to resting orders and quotes at the opening price. See Rule 6.2B(c)(iv).

that complies with the legal width quote requirements of Rule 8.7(b)(iv) has been entered by at least one Market-Maker appointed to the class (or by the Designated Primary Market-Maker or Lead Market-Maker, if applicable for the particular class) (the "opening quote condition"); (2) the opening price is not within an acceptable range (as applicable for the particular class) compared to the lowest quote offer and the highest quote bid (the "acceptable opening range condition"); or (3) 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) ("market order imbalance condition").

Under the current HOSS procedures, if the opening quote condition or acceptable opening range condition is present, the senior official in the Exchange's control room may authorize the opening of the affected series where necessary to ensure a fair and orderly market. If the acceptable opening range condition is present, HOSS will not open the series but will send a notification to market participants indicating the reason. If the market order imbalance condition is present, 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 condition causing the delay is satisfied. HOSS will repeat the process until the series is open.[5]

CBOE proposes to amend the current HOSS procedures in CBOE Rule 6.2B to permit HAL functionality to be available on the openings in designated classes. HAL is a system for automated handling of electronically received orders that are not automatically executed upon receipt by Hybrid.[6] Under the proposed rule change, the Exchange could designate the classes in which HAL would be activated for HOSS openings. For such designated classes, additional steps would be automatically taken using HAL functionality to address the opening quote,

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5 See CBOE Rule 6.2B(f).

6 See CBOE Rule 6.14 (governing the operation of HAL).

acceptable opening range, and market order imbalance conditions, as well as to address instances where CBOE's opening trade would be at a price that is not the current national best bid or offer (the "NBBO condition").

In particular, CBOE proposes that for classes where HAL is activated for HOSS openings, the following procedures would apply if one of the following conditions is met:

(1) If the opening quote condition is present, HOSS would check to see if there is an NBBO quote on another market that falls within the acceptable opening range. If such an NBBO quote is present, the series would open and expose the marketable order(s) at the NBBO price. If such an NBBO quote is not present, HOSS would not open the series and would send a notification to market participants indicating the reason.

(2) If the acceptable opening range condition is present, HOSS would match orders and quotes to the extent possible at a single clearing price[7] within the acceptable opening range and then expose the remaining marketable order(s) at the widest price point within the acceptable opening range or the NBBO price, whichever is better.

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[7] In determining the priority of orders and quotes to be traded on the opening trade or through the subsequent exposure process, HOSS would give priority to public customer market orders first (with multiple orders ranked based on time priority), then to non-public customer market orders second (with multiple orders being ranked based on time priority), then to limit orders and quotes whose price is better than the opening price (with multiple orders and quotes being ranked in accordance with the allocation algorithm in effect for the option class pursuant to CBOE Rule 6.45A, "Priority and Allocation of Equity Option Trades on the CBOE Hybrid System," or 6.45B, "Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System)," and then to limit orders and quotes at the opening price (with multiple orders and quotes being ranked in accordance with the allocation algorithm in effect for the option class pursuant to Rule 6.45A or 6.45B). See proposed Interpretation and Policy .03(c)(i) to Rule 6.2B.

(3) If the market order imbalance condition is present, HOSS would match orders and quotes to the extent possible at a single clearing price and then expose the remaining marketable order(s) at the widest price point within the acceptable opening range or the NBBO price, whichever is better.

(4) If the NBBO condition is present, HOSS would match orders and quotes to the extent possible at a single clearing price within the acceptable opening range or the NBBO price, whichever is better, and then expose the remaining marketable order(s) at the NBBO price.

The order exposure process in each of the above would be conducted pursuant to Rule 6.14, "Hybrid Agency Liaison (HAL)." Under the HAL process, marketable orders would be electronically exposed to all Market-Makers appointed to the relevant option class if not executed at a single clearing price.[8] For HOSS openings where HAL is used, this exposure period would afford Market-Makers appointed to the class an opportunity to match the widest price point within the opening range or the NBBO price, whichever is better. If at least one Market-Maker committed to trade any portion of the exposed marketable order(s) during the exposure period, the exposure period would end and an allocation period would commence. The

[8] On an intra-day basis, orders are normally exposed through HAL to Market-Makers appointed to the relevant option class as well as members acting as agent for orders at the top of CBOE's book ("Qualifying Members") in the relevant series. See CBOE Rule 6.14(b). For HOSS openings where HAL is used, the exposure to Qualifying Members would not be applicable because there would not be an established "top of CBOE's book" at the time. As part of a separate rule filing, the Exchange recently modified Rule 6.14 to permit electronic exposure of HAL orders on a class-by-class basis to all members that elect to receive HAL messages (not just Market-Makers appointed to the relevant option class and Qualifying Members) and to permit such members to participate in the HAL process. See Securities Exchange Act Release No. 57837 (May 20, 2008), 73 FR 30431 (May 27, 2008) (SR-CBOE-2008-46). In classes where all members that elect to receive HAL messages are eligible to participate in the HAL process for a particular class on an intra-day basis, all such members would also be eligible to participate in any HAL process that occurs as part of the HOSS opening in that class.

Exchange would determine on a class-by-class basis the applicable exposure period (which would not exceed 1.5 seconds) and allocation period (which, when combined with the designated exposure period time – as opposed to an exposure period that is terminated early[9] – would not exceed a total of 3 seconds) that would be applicable where HAL is activated for HOSS openings.

At the conclusion of the allocation period, the order(s) would be filled in accordance with the allocation algorithm in effect for the class pursuant to Rule 6.45A or 6.45B. There would be no participation entitlement applicable to exposed orders, and response sizes are limited to the size of the exposed order for allocation purposes. If no responses are received or if there remains an unexecuted marketable order (or portion thereof), then the balance of the order would be booked if it is a limit order that is not marketable or processed in accordance with CBOE Rule 6.14(b)(i)-(ii).[10] In addition, for all classes, any remaining balance of opening contingency orders not executed via HAL on the opening would be automatically cancelled.[11] For single list classes, any remaining balance of marketable orders (other than opening contingency orders) not executed via HAL on the opening would route as determined by the Exchange on a class-by-

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9 In addition to the receipt of a response to trade any portion of the exposed order(s), the exposure period would also terminate early under the circumstances described in CBOE Rule 6.14(d).

10 With respect to new proposed HAL exposure period, "Exchange Initial BBO" in CBOE Rule 6.14(i) – (ii) means the best bid (or offer) that exists in the system at the time the auction begins. This takes into account orders and quotes on the relevant side of the market that exist in the system at that time (including orders and quotes that may have been entered up until the beginning of the HAL auction). See email from Jennifer Lamie, Assistant General Counsel, CBOE, to Sara Gillis, Special Counsel, Division, Commission, dated June 19, 2008.

11 See proposed CBOE Rule 6.2B, Interpretation .03(c)(ii).

class basis to PAR, BART, or at the order entry firm's discretion to the order entry firm's booth printer.[12]

The Exchange also notes that all transactions executed via HOSS, including through the new proposed HAL exposure period, must be in compliance with Section 11(a) of the Act[13] and the rules promulgated thereunder. In this regard, the Exchange states that it believes that orders for proprietary accounts submitted into HOSS, including any such orders submitted as a response through the proposed HAL exposure period, would qualify for an exception under Rule 11a2-2(T).[14]

III. Discussion

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.[15] Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[16] which requires, among other things, that the rules of a national securities exchange be designed 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 proposed rule change will reduce delays in the opening of a series where the opening quote, acceptable opening range, and market order imbalance conditions (collectively, "opening conditions") currently would cause the Exchange to delay the

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12 See proposed CBOE Rule 6.2B, Interpretation .03(c)(ii).

13 15 U.S.C. 78k(a).

14 17 CFR 240.11a2-2(T).

15 In approving this 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).

16 15 U.S.C. 78f(b)(5).

opening of a series until the condition causing the delay is satisfied. Under the current HOSS procedures, the Exchange must undertake a manual process when one of the opening conditions exits, which includes notifying members of the existence of one of the opening conditions and waiting for the condition(s) to be remedied. The proposed rule change would automate the process for addressing the opening conditions by allowing the HAL functionality to be enabled on the openings in designated classes. Specifically, rather than preventing a series from opening, the Exchange's system will match orders and quotes to the extent possible and then expose the remaining marketable orders to HAL. The Commission believes that this may enhance the efficiency of HOSS opening rotations because it will allow the opening conditions to be addressed more quickly through the automated HAL process, as well as address NBBO condition scenarios where the Exchange's opening trade might occur at a price inferior to an away market.

Section 11(a)(1) of the Act[17] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T) under the Act, known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;[18] (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the

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17 15 U.S.C. 78k(a).

18 The member may, however, participate in clearing and settling the transaction.

member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

The Rule's first condition is that orders for covered accounts must be transmitted from off the exchange floor. The HOSS system receives orders electronically through remote terminals or computer-to-computer interfaces.[19] In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.[20] Since HOSS receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that such orders satisfy the off-floor transmission requirement. However, the Commission notes that to the extent a member submits an order for a covered account into HOSS from on the floor of the Exchange, such an order would not meet this requirement.

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[19] See email from Jennifer Lamie, Assistant General Counsel, CBOE, to Sara Gillis, Special Counsel, Division of Trading and Markets, Commission, dated July 31, 2008.

[20] See, e.g., Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (order approving The NASDAQ Options Market as an options exchange facility of The NASDAQ Stock Market ("Nasdaq")); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (order approving Nasdaq's application to register as a national securities exchange); 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving Archipelago Exchange as electronic trading facility of the Pacific Exchange ("PCX")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding the New York Stock Exchange's ("NYSE") Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

Second, the Rule requires that the member not participate in the execution of its order. CBOE represented that no Exchange member is able to acquire control or influence over the result or timing of an order's execution through HOSS. According to CBOE, the execution of a member's order through HOSS, including the subsequent HAL exposure, is determined solely by automated processing and execution by computerized systems.[21] Accordingly, the Commission believes that a member does not participate in the execution of an order submitted to HOSS.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this requirement is satisfied when automated exchange facilities are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.[22] CBOE has represented that the design of HOSS, including the new HAL exposure period, ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to the Exchange and is designed to prevent any Exchange members from gaining any time or place

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21 The member may cancel or modify the order, or modify the instruction for executing the order. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See 1978 Release, supra note 20 (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor.") Thus, the Commission notes that if such orders are cancelled or modified from on the floor of the Exchange, such orders would not meet this requirement of Rule 11a2-2(T).

22 In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, supra note 20.

advantages. Based on CBOE's representation, the Commission believes that HOSS, as amended herein, satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).[23] CBOE represents that members trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.[24]

Accordingly, for the reasons stated above, the Commission finds that the proposed rule change is consistent with the Act.

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23 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 20 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

24 See email from Jennifer Lamie, Assistant General Counsel, CBOE, to Sara Gillis, Special Counsel, Division of Trading and Markets, Commission, dated July 31, 2008.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[25] that the proposed rule change (SR-CBOE-2008-30) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[26]

Florence E. Harmon
Acting Secretary

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25 15 U.S.C. 78s(b)(2).

26 17 CFR 200.30-3(a)(12).