

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57357; File No. SR-CBOE-2008-14)

February 20, 2008

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

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 February 7, 2008, 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 CBOE. 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

CBOE proposes 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 text of the proposed rule change is available on the Exchange’s Web site at (<http://www.cboe.org/Legal>), at the 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

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 the places specified

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

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

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

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>3</sup> Currently, an order entry firm can comply with this requirement by entering the Agency Order on the Exchange, waiting 3 seconds, and then entering the solicited order. The Exchange states that, due to 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>4</sup>

To better compete with various other electronic alternatives available at other options exchanges, 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 proposed rule change 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-

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<sup>3</sup> See CBOE Rule 6.45A.02 and 6.45B.02.

<sup>4</sup> See CBOE Rule 6.74A, Automated Improvement Mechanism (“AIM”).

or-none limit (“AON”) orders,<sup>5</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 \$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>6</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

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<sup>5</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.

<sup>6</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](#).

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>7</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.

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

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>8</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.

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<sup>7</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.

<sup>8</sup> See CBOE Rules 6.45A.01, 6.45B.01, 6.74, Crossing Orders, and 6.74A.

Finally, the Exchange is proposing to expand its existing AIM auction, which currently only applies to simple orders, to cover complex orders. Thus, 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 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.

## 2. Statutory Basis

The Exchange believes that 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 prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, 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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<sup>9</sup> 15 U.S.C. 78f(b).

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

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

Written comments on the proposed rule change were neither solicited nor received.

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 Exchange 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-2008-14 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-2008-14. 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, 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 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-2008-14 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.<sup>11</sup>

Florence E. Harmon  
Deputy Secretary

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