

Exchange's surveillance capabilities have made it possible to approve the elimination of position and exercise limits on certain broad-based index options. Thus, in 2001, the Commission approved a CBOE proposal to eliminate permanently position and exercise limits for options on the SPX, OEX, and DJX.<sup>11</sup>

The Commission believes that the considerations upon which it relied in approving the elimination of position and exercise limits for SPX, OEX, and DJX options equally apply with respect to options on the NDX.

As noted by the CBOE, the market capitalization of the NDX as of the date of filing of the proposal was \$1.84 trillion. The ADTV for the period three months prior to the date of filing of the proposed rule change for all underlying components of the index was 420 million shares. The Commission believes that the enormous market capitalization of the NDX and the deep, liquid market for the underlying component securities significantly reduce concerns regarding market manipulation or disruption in the underlying market. Removing position and exercise limits for NDX options may also bring additional depth and liquidity, in terms of both volume and open interest, to NDX options without significantly increasing concerns regarding intermarket manipulation or disruption of the options or the underlying securities.

In addition, the Commission believes that financial requirements imposed by both the Exchange and the Commission adequately address concerns that a CBOE member or its customer may try to maintain an inordinately large unhedged position in NDX options. Current risk-based haircut and margin methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer.<sup>12</sup> Under the proposal, the CBOE also would have the authority under its rules to impose a higher margin requirement upon an account maintaining an under-hedged position when it determines a higher requirement is warranted. As noted in the CBOE rules, the clearing firm carrying the account would be subject to capital charges under Rule 15c3-1 under the Act to the extent of any

margin deficiency resulting from the higher margin requirement.

Finally, in approving the elimination of position and exercise limits for options on the SPX, OEX, and DJX, the Commission took note of the enhanced surveillance and reporting safeguards that the CBOE had adopted to allow it to detect and deter trading abuses that might arise as a result.<sup>13</sup> The CBOE represents that it monitors trading in NDX options in much the same manner as trading in SPX, OEX, and DJX options. These safeguards, including the 100,000-contract reporting requirement described above, would allow the CBOE to monitor large positions in order to identify instances of potential risk and to assess and respond to any market concerns at an early stage. In this regard, the Commission expects the CBOE to take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in component stocks, should any unanticipated adverse market effects develop. Moreover, as previously noted, the Exchange has the flexibility to specify other reporting requirements, as well as to vary the limit at which the reporting requirements may be triggered.

The Commission further notes that in eliminating position and exercise limits for FLEX NDX options, the CBOE is adopting the same additional rules for these options as for FLEX SPX and OEX options.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>14</sup> that the proposed rule change (SR-CBOE-2005-41) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Jonathan G. Katz,**  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52659; File No. SR-CBOE-2005-85]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Rule Change To Adopt a Market Turner Priority for Index Options and Options on ETFs on the Exchange's Hybrid System

October 24, 2005.

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 October 14, 2005, 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 and II below, which Items have been prepared by the CBOE. The Exchange has filed the proposal pursuant to Section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the Commission. 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 modify its Hybrid System rule regarding priority and allocation of trades in index options and options on ETFs to adopt a market turner priority. The Exchange has designated this proposal as non-controversial and has requested that the Commission waive the 30-day pre-operative waiting period contained in Rule 19b-4(f)(6)(iii) under the Act.<sup>5</sup> The text of the proposed rule change is available on CBOE's Web site (<http://www.cboe.com>), at the CBOE'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

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>5</sup> 17 CFR 240.19b-4(f)(6)(iii).

<sup>11</sup> See SPX/OEX/DJX Permanent Approval Order, *supra* note 5.

<sup>12</sup> See SPX/OEX/DJX Pilot Approval Order, *supra* note 5.

<sup>13</sup> See, in particular, SPX/OEX/DJX Pilot Approval Order, *supra* note 5.

<sup>14</sup> 15 U.S.C. 78s(b)(2).

<sup>15</sup> 17 CFR 200.30-3(a)(12).

any comments it received on the proposed rule change. The text of these 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 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 add a market turner priority (which has already been approved for CBOE's screen-based trading ("SBT") rules)<sup>6</sup> to its Hybrid trading rules for index options and options on ETFs.

In April 2003, the Commission approved the CBOE's SBT rules (Chapters 40–46).<sup>7</sup> CBOE Rule 43.1 is the matching algorithm rule applicable to trading on the SBT platform.<sup>8</sup> The Exchange states that, essentially, CBOE Rule 43.1 calls for the use of either price-time priority or pro-rata priority as the base order allocation methodology. The rule then allows for three additional priority overlays: Public customer priority for public customer orders resting on the SBT system; participation right guarantees for certain qualifying market-makers; and a market turner priority for participants that are first to improve the CBOE's disseminated quote. These overlays are optional.

The Exchange states that recently approved CBOE Rule 6.45B,<sup>9</sup> relating to priority and order allocation for index options and options on ETFs trading on the Exchange's Hybrid System, is based in part on CBOE Rule 43.1 in that it allows for the selection of price-time or pro-rata as an order allocation methodology (CBOE's Ultimate Matching Algorithm is also an option) and allows for customer priority and participation entitlement overlays. The Exchange now seeks to add a market turner overlay to CBOE Rule 6.45B so that index products trading on the Hybrid System may trade with a market turner priority.

Here is how the market turner priority overlay works under CBOE Rule 43.1: assume the pro-rata allocation methodology is in place for option class ABC and that no other overlays are in

effect. Also assume that the market for a particular series is 1.00–1.15. If Market-Maker A enters a bid for 1.05 for 100 contracts, Market-Maker A becomes the market turner at 1.05. To the extent others join the 1.05 bid, Market-Maker A would have priority at that price until its bid size is exhausted. Thus, the market turner will receive 100% of an incoming order until its quote is exhausted. This is true even if a 1.10 bid is entered and is then traded while the market turner's 1.05 bid remains unexecuted (*i.e.*, the market turner priority at a given price is retained once it is earned, even if the disseminated quote changes).

The Exchange is proposing to add this priority overlay to its index Hybrid rules,<sup>10</sup> but with flexibility to allow the Exchange to allocate less than 100% of an incoming order to the market turner. For example, taking the same facts as the example described above, assume that the Exchange has in place a 40% allocation for market turners and that Market-Maker A is joined at 1.05 by Market-Maker B for 60 contracts and Market-Maker C for 60 contracts. Also assume a sell market order is received for 100 contracts. As proposed, Market-Maker A would have priority for 40 contracts. The remaining 60 contracts would be divided pro-rata between all three participants at 1.05 (20 contracts to each). Thus, with this "modified" market turner priority, Market-Maker A receives 60 contracts of the order (but is only guaranteed 40), whereas under CBOE Rule 43.1, Market-Maker A would be guaranteed 100 contracts. The Exchange states that this is the only material difference between CBOE Rule 43.1 and what the Exchange is proposing to adopt for CBOE Rule 6.45B.

The Exchange is also clarifying in the proposed rule that the market turner priority only remains in effect for the duration of the trading day and that it cannot be established until after the opening rotation.

Finally, the Exchange notes that, like public customer priority and the participation entitlement, the market turner priority is optional. The Exchange states that the appropriate Exchange procedures committee would determine whether one or more of these priority overlays would apply to a product and if more than one is selected, the sequence in which they would apply (consistent with applicable rules). The Exchange states that all determinations would be set forth in a regulatory circular.

<sup>10</sup> The Exchange states that most options trading on CBOE currently trades on the Hybrid System.

2. Statutory Basis

The Exchange states that this change will provide it with another method to reward aggressive pricing in index options and options on ETFs trading on the Hybrid System. Accordingly, the Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>11</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>12</sup> in particular, in that the rules of an exchange be designed to promote just and equitable principles of trade, and to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will result in 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 were neither solicited nor received.

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

The foregoing proposed rule change is subject to Section 19(b)(3)(A)(iii) of the Act<sup>13</sup> and Rule 19b-4(f)(6) thereunder<sup>14</sup> because the proposal: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative prior to 30 days after the date of filing or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the Exchange has given the Commission notice of its intent to file the proposed rule change, along with a brief description and text of 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 CBOE has satisfied the five-day pre-filing requirement. In addition, the Exchange has requested that the Commission waive the 30-day operative delay. The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest because such waiver will permit the Exchange to implement the proposed

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

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>14</sup> 17 CFR 240.19b-4(f)(6).

<sup>6</sup> See Securities Exchange Act Release No. 47628 (Apr. 3, 2003), 68 FR 17697 (Apr. 10, 2003) (SR-CBOE-00-55) ("SBT Order").

<sup>7</sup> See SBT Order.

<sup>8</sup> The Exchange states that no products currently trade pursuant to the SBT rules.

<sup>9</sup> See Securities Exchange Act Release No. 51822 (Jun. 10, 2005), 70 FR 35321 (Jun. 17, 2005) (SR-CBOE-2004-87).

rule change without delay and thereby provide an incentive to parties on the Exchange to quote more aggressively as soon as possible. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.<sup>15</sup>

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.<sup>16</sup>

#### 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-2005-85 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2005-85. 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. Copies of the 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-2005-85 and should be submitted on or before November 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 52652; File No. SR-CHX-2004-17]

### Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Approving Proposed Rule Change To Amend Article XX, Rule 37(a)(3) To Eliminate its Requirement That Specialists Guarantee Execution of Limit Orders When Certain Conditions Occur in Another Market

October 21, 2005.

#### I. Introduction

On June 21, 2004, the Chicago Stock Exchange, Inc. ("CHX" 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 proposed rule change to amend Article XX, Rule 37(a)(3) of its rules to permit, rather than require, CHX specialists to guarantee execution of limit orders when certain conditions occur in another market. On July 5, 2005, the CHX filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on July 14, 2005.<sup>4</sup> The Commission received no comments on the proposal.

This order approves the proposed rule change, as amended.

#### II. Description of the Proposal

The Exchange proposes to amend Article XX, Rule 37(a)(3), which provides for execution of resting limit orders based on activity in other markets, to eliminate the requirement that CHX specialists guarantee execution of such limit orders when certain conditions occur in another market. For listed issues, the current rule generally obligates a CHX specialist to guarantee execution of limit orders resting in the specialist's book when the issue is being traded in the primary market at a price equal to or better than the limit price. [For Nasdaq securities, the rule permits, but does not require, a CHX specialist to guarantee execution of limit orders resting in the specialist's book, when another market center's quotation locks or crosses the limit price.] The CHX represents that the guarantees set forth in Article XX, Rule 37(a)(3), commonly referred to as "limit order protection" or "primary market protection," were voluntarily adopted by the Exchange over 15 years ago to attract order flow.

Under the proposed revision to Article XX, Rule 37(a)(3), the mandate that CHX specialists guarantee execution of resting limit orders for listed issues, based on triggering activity in other markets, would be deleted. Instead, the amended rule would permit CHX specialists to continue to provide such limit order protection guarantees solely on an issue-by-issue basis, on non-discriminatory terms approved by the Exchange. The Exchange's existing functionality providing for automated execution of resting limit orders would remain available for CHX specialists who elect to continue to guarantee limit order protection.<sup>5</sup>

The CHX provided the following rationale for the proposed rule change. First, as the industry has evolved, the Exchange's principal competitors for order flow, namely "third market" execution venues and alternative trading systems, do not provide comparable limit order protection guarantees. In addition, CHX order-sending firms now have free access to comprehensive monthly order execution

<sup>5</sup> The CHX anticipates that for the foreseeable future, CHX specialists would continue to provide limit order protection voluntarily using the criteria for limit order protection previously set forth in Article XX, Rule 37(a)(3). Should the CHX receive a request from a specialist to alter the voluntary limit order protection criteria and agree to alter the functionality, the Exchange will notify all CHX participants of the change. The Commission believes any such change would need to be filed pursuant to Section 19(b) of the Act.

<sup>15</sup> For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>16</sup> See Section 19(b)(3)(C) of the Act, 15 U.S.C. 78s(b)(3)(C).

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

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

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

<sup>3</sup> See Amendment No. 1.

<sup>4</sup> See Securities Exchange Act Release No. 51997 (July 8, 2005), 70 FR 40760.