Section. Copies of such filing also will be available for inspection and copying at the principal office of the Amex. 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 No. SR–Amex–2006–008 and should be submitted on or before March 3, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[13]

Jill M. Peterson,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–53222; File No. SR–CBOE–2005–60]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change Relating to an Automated Improvement Mechanism

February 3, 2006.

I. Introduction

On August 5, 2005, 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 adopt an electronic price improvement mechanism. On September 2, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The proposed rule change, as amended, was published for comment in the **Federal Register** on October 18, 2005.[4] On October 12, 2005, the Exchange filed Amendment No. 2 to the proposed rule change.[5] The Commission received two comment letters with respect to the amended proposal,[6] and on December 2, 2005, the Exchange filed its response to the comment letters.[7] This order approves the proposed rule change as amended by Amendment No. 1, notices and solicits comments on Amendment No. 2, and grants accelerated approval to Amendment No. 2.

II. Description of the Proposal

The Exchange proposes to establish an electronic auction system (Automated Improvement Mechanism or ''AIM''), which would expose certain orders electronically in an auction to provide such orders with the opportunity to receive an execution at an improved price.

The AIM auction is available only for orders that an Exchange member represents as an agent (''Agency Order''). To initiate the electronic auction, the Exchange member (''Initiating Member'') who represents an Agency Order would submit the Agency Order and a second order for the same size as the Agency Order (on the opposite side of the Agency Order) into the auction. If the Agency Order is for less than 50 contracts, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of (A) the national best bid or offer (''NBBO'') price improved by one minimum price improvement increment, which increment shall be determined by the Exchange but may not be smaller than one cent or (B) the Agency Order's limit price (if the Agency Order is a limit order). If the Agency Order is for 50 contracts or more, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of the NBBO or the Agency Order's limit price (if the Agency Order is a limit order). Thereafter, other Exchange participants would compete with the Initiating Member's second order to execute against the Agency Order. The second order submitted by the Initiating Member could be an order for the principal account of the Initiating Member (''principal order'') or an order solicited by the Initiating Member to trade with another member or a non-member customer or broker-dealer (''solicited order'').[8] Under the proposal, the Initiating Member may enter the second order in one of two formats: (1) At a specified single price or (2) with a non-price specific commitment to match as principal the price and size of all auction responses (''Auto-Match''). If the Initiating Member enters the second order with Auto-Match, then the Initiating Member would not have control over the prices at which it receives an allocation at the conclusion of the auction. After the commencement of an auction, the Initiating Member would not be able to cancel the auction.

Upon receipt of an Agency Order and the second order, the Exchange would commence the auction by issuing a request for responses (''RFR'') detailing the side and size of the Agency Order.[9] The auction would last for a random time period, from 3 seconds to 5 seconds, determined by the Exchange's system. During such time period, any Exchange market maker with an appointment in the options class may submit RFR responses (including multiple responses). In addition, any Exchange member acting as an agent for customer orders resting at the top of the Exchange's book opposite the Agency Order, may submit RFR responses on behalf of such customer orders (such RFR responses may not exceed the size of the customer orders).[10] The RFR responses must specify price and size, and may not cross the Exchange's quote on the opposite side of the market as the Agency Order. All RFR responses would be ''blind,'' *i.e.*, the RFR responses would not be visible to any other participants in the auction. Under the proposal, market makers may modify or cancel RFR responses prior to the conclusion of the auction. The Exchange may set the RFR response minimum price increment at no less than one cent.

Normally, the auction would end at the conclusion of the random 3 seconds

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[13] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Amendment No. 1 superseded and replaced the proposed rule filing in its entirety.

[4] *See* Securities Exchange Act Release No. 52577 (October 7, 2005), 70 FR 60586.

[5] In Amendment No. 2, the CBOE proposes to amend proposed CBOE Rule 6.74A(b)(1)(E) so that members, not floor brokers, may submit RFR responses on behalf of customer orders resting at the top of the Exchange book. Amendment No. 2 also would amend proposed CBOE Rule 6.74A.06 with respect to information that the Exchange may provide to the Commission regarding a pilot program that would end on July 18, 2006.

[6] *See* letters to Jonathan G. Katz, Secretary, Commission, from Matthew B. Hinerfeld, Managing Director & Deputy General Counsel, Citadel Investment Group, LLC on behalf of Citadel Derivatives Group LLC (''Citadel''), dated November 8, 2005 (''Citadel Letter'') and from Annah Y. Kim, Chief Regulatory Officer, Boston Options Exchange Regulation (''BOX''), dated November 10, 2005 (''BOX Letter''). Citadel also commented on the American Stock Exchange LLC's (''Amex'') proposal to implement the Amex New Trading Environment Price Improvement Auction (''PIA'') (File No. SR-Amex-2004–107). This Order and Notice does not address the Amex proposal. A discussion of the comment letters is provided in section III below.

[7] *See* letter from Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, to Jonathan G. Katz, Secretary, Commission, dated December 2, 2005 (''Response Letter'').

[8] *See* CBOE Rule 6.9 for a definition of solicited order.

[9] The Exchange would send each RFR to all members electing to receive RFRs (*i.e.*, those members who have established the necessary systems connectivity to receive RFRs). Thus, an Exchange member's election to receive RFRs would not be on an auction-by-auction basis.

[10] *See* Amendment No. 2, *supra* note 5.

to 5 seconds time period. However, under the proposal, the following events could prematurely end the auction: (1) If the Exchange Hybrid System receives an unrelated order in the same series as the Agency Order and such unrelated order is marketable against the Exchange's disseminated quote (when the quote is the NBBO) or the RFR responses; (2) if the Exchange Hybrid System receives an unrelated non-marketable limit order in the same series and on the opposite side of the market as the Agency Order that improves any RFR response; (3) any time an RFR response matches the Exchange's disseminated quote on the opposite side of the market; or (4) pursuant to a pilot program that would expire on July 18, 2006, any time there is a market maker to market maker quote lock on the Exchange in accordance with CBOE Rule 6.45A(d).[11]

At the conclusion of the auction, the Agency Order would be allocated in accordance with applicable matching algorithm rules in effect for such option class subject to the following provisions. First, no participation entitlement would apply with respect to an AIM execution. Second, public customer orders in the Exchange book would have priority. Third, if the Exchange received an unrelated market order or marketable limit order on the opposite side of the Agency Order which prematurely ended the auction, such unrelated order would trade against the Agency Order at the midpoint of the best RFR response and the NBBO on the other side of the market (rounded towards the disseminated quote when necessary).[12] Fourth, if the Exchange received an unrelated non-marketable limit order on the opposite side of the Agency Order which prematurely ended the auction, such unrelated limit order would trade against the Agency Order at the midpoint of the best RFR response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary).[13] Fifth, if the best price equals the Initiating Member's single-price submission, the Initiating Member's single-price submission would be allocated the greater of one contract or 40% of the order. However, if only one market maker matches the Initiating Member's single price submission, then the Initiating Member would be allocated 50% of the order. Sixth, if the Initiating Member selected Auto-Match for the second order, then the Initiating Member would be allocated its full size at each price point until a price point is reached where the balance of the order can be fully executed. At such price point, the Initiating Member would be allocated the greater of one contract or 40% of the remainder of the order. Seventh, if the auction does not result in price improvement over the Exchange's disseminated price at the commencement of the auction, resting unchanged quotes or orders that were disseminated at the best price before the auction started would have priority, after any public customer order priority and the Initiating Member's priority (40%) have been satisfied. Any unexecuted balance on the Agency Order would be allocated to RFR responses pursuant to the matching algorithm except that the RFR responses would be capped to the size of the unexecuted balance and the Initiating Member may not participate on any such balance unless the Agency Order would otherwise go unfilled. Finally, if the final auction price locks a customer order on the book on the same side as the Agency Order, then unless there is sufficient size in the RFR responses to execute both the Agency Order and the booked customer order (in which case they would both execute at the final auction price), the Agency Order would execute against the RFR responses at one minimum RFR response increment worse than the final Auction price against the auction participants that submitted the final auction price, and any balance would trade against the customer order in the book at such order's limit price.

If an unexecuted balance remains on the RFR responses after the Agency Order has been executed and such balance could trade against any unrelated order(s) that caused the auction to conclude, then the RFR response balance would trade against the unrelated order(s).

The CBOE proposes several interpretations and policies to proposed CBOE Rule 6.74A. First, an Initiating Member would be permitted to use the auction only when there is a genuine intention to execute a bona fide transaction. Second, a pattern or practice of submitting unrelated orders that cause an auction to prematurely conclude would be deemed conduct inconsistent with just and equitable principles of trade and a violation of CBOE Rule 4.1 and other Exchange Rules. Third, initially, and during a Pilot Period, which would end on July 18, 2006, there would be no minimum size requirement for orders to be eligible for the auction. During this Pilot Period, the Exchange would submit on a confidential basis certain data, periodically as required by the Commission, to provide supporting evidence that, among other things, there is meaningful competition for all size orders and that there is an active and liquid market functioning on the Exchange outside of the auction mechanism. Fourth, any solicited orders submitted by the Initiating Member to trade against the Agency Order would not be permitted to be for the account of a market maker assigned to the option class. Fifth, the Exchange would communicate any Exchange determinations pursuant to the proposed rule such as eligible classes, order size parameters, and the minimum price increment for RFR responses, in a Regulatory Circular. Finally, proposed CBOE Rule 6.74A(b)(2)(E), which would end the auction due to a lock on the CBOE market, would operate as a pilot program until July 18, 2006.

III. Discussion and Commission Findings

After careful review of the amended proposal and consideration of the comment letters and the Response Letter, the Commission finds that the proposed rule change, as amended, to establish rules for the implementation of the AIM auction, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange[14] and, in particular, the requirements of section 6 of the Act.[15] Specifically, as discussed in detail below, the Commission finds that the proposal is consistent with section 6(b)(5) of the Act,[16] which requires, in part, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation

[11] In connection with this pilot program, pursuant to proposed CBOE Rule 6.74A.06, the Exchange would provide the Commission data (on a confidential basis) regarding the frequency of early terminations of the auction, and also the frequency of early terminations pursuant to this provision that result in favorable pricing for the Agency Order. *See* Amendment No. 2, *supra* note 5.

[12] For example, if an auction is underway for an Agency Order to buy and the CBOE quote (as well as the NBBO) is 1–1.15, with the RFRs at 1.12 and an unrelated market order to sell is received by the Exchange, the unrelated order would execute against the Agency Order at 1.06 (the midpoint of the best RFRs and the NBBO on the other side of the market, *i.e.*, the best bid).

[13] For example, using the same scenario as above except the unrelated order is a non-marketable limit order to sell at 1.10, the unrelated order would execute against the Agency Order at 1.11 (the midpoint of the best RFRs (1.12) and the unrelated order's limit price (1.10)).

[14] In approving this proposal, the Commission has considered the proposed rule change's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[15] 15 U.S.C. 78f.

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

and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities, 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. Section 6(b)(5) of the Act [17] also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

The Commission believes that approving the Exchange's proposal to establish the AIM should confer benefits to the public by increasing competition between and among the options exchanges, resulting in better prices and executions for investors. The Commission also believes that access to the AIM auction for those who may wish to compete for an Agency Order should be sufficient to provide opportunities for a meaningful, competitive auction. The Commission therefore finds that for the reasons discussed below, the Exchange's proposal is consistent with the Act.

A. Internalization

In its comment letter, Citadel asks the Commission to reject the proposal because the AIM auction and other similar auctions encourage internalization, which Citadel believes would hinder price discovery and harm investors with worse prices.[18] Citadel states that these auctions harm the options markets and investors by hindering price discovery, discouraging aggressive quoting, eliminating substantial price improvement by diminishing the ability of customers to interact with one another; and undercutting customer limit orders.[19] Therefore, Citadel urges the Commission to reevaluate the auctions currently in operation [20] and determine whether such auctions should operate.[21]

In the Response Letter, the Exchange states that it should be allowed to adopt the AIM auction for competitive reasons, since other options exchanges have similar auctions, and if the Commission were to take any actions with respect to these auctions, such actions should affect the options exchanges equally at the same time.[22]

After considering the Citadel Letter and the Response Letter, the Commission believes that the Citadel Letter does not raise any novel regulatory concerns that would preclude the approval of the proposed rule change. The Commission believes that the proposed CBOE AIM auction provides limitations on internalization comparable to the other exchanges' rules that guarantee members the right to internalize their customers' orders. Specifically, like the auction rules previously approved by the Commission, the proposed AIM rules require the Initiating Member to expose the Agency Order in the auction before the Initiating Member may trade with the Agency Order.

B. Solicitation Process

Proposed CBOE Rule 6.74A permits a member that represents an Agency Order to execute that Agency Order in the AIM auction against principal interest or against a solicited order. BOX argues that the proposal should define how the Initiating Member solicits the other side of the Agency Order. BOX contends that the proposed rules need to clarify the parameters for a market maker and the Initiating Member's ability to access customer information that may be derived from solicited orders and agency orders. BOX notes that the Commission required BOX to codify procedural protections on BOX's Directed Order process (which it termed its version of a solicitation process), and BOX believes that it would be placed at a competitive advantage if the Commission does not require CBOE to adopt similar procedural protections. Finally, BOX notes that brokers in the options industry generally limit solicitation of large customer orders (*e.g.*, greater than 300 contracts). BOX believes that the Exchange should clarify why the proposal would permit solicitation of orders of all sizes, particularly for orders of less than 50 contracts.[23]

In the Response Letter, the Exchange notes that solicited orders are processed on the floor of all floor-based options exchanges. The Exchange contends that ISE's PIM is identical to the proposed rule change in that the PIM auction rules allow the initiating member to pair the agency order with a facilitation order or a solicitation order. Further, CBOE notes that ISE's rules do not contain elaborate procedures regarding the solicitation process. The Exchange further notes that unlike the BOX Directed Order process, the AIM proposal provides that solicited orders submitted by the Initiating Member may not be for the account of a market maker assigned to the option class. Thus, the CBOE contends that any comparison between the AIM auction and BOX's Directed Order process is not relevant. Finally, with respect to the size of a solicited order, the Exchange believes that unless other options exchanges adopt size limits, it would be inappropriate for the Commission to require that the CBOE impose such size limitations on solicited orders for the AIM auction.[24]

The Commission believes that the proposal regarding solicitation process is sufficiently clear. The Commission notes that CBOE Rule 6.9 limits solicitation from members or non-member customers or broker-dealers.[25] In addition, CBOE Rule 4.1 prohibits members from engaging in acts or practices inconsistent with just and equitable principles of trade.[26] The Commission further notes that CBOE has proposed an additional limitation in CBOE Rule 6.74A.04 that would require that any solicited orders submitted by the Initiating Member to trade against the Agency Order not be for the account of a Market-Maker assigned to the option class. The Commission believes that these provisions should permit members to solicit, in advance, the other side of an order, while providing for adequate disclosure of such orders to limit manipulation and abuse.

C. Competition in the AIM

Proposed CBOE Rule 6.74A(a)(4) would require that there be at least three Market Makers quoting in a relevant series at the time an Initiating Member submits its Agency Order into the AIM.[27] The Commission believes that this requirement should improve the opportunity for an Agency Order to be exposed to a competitive auction.[28]

BOX questions how public customers may participate in the RFR.[29] The Exchange proposes to clarify in Amendment No. 2 that members acting as agent for orders resting at the top of the Exchange's book opposite the Agency Order may submit responses to

[17] *Id.*

[18] *See* Citadel Letter, *supra* note 6, at p.1.

[19] *Id.* at pp. 3–4.

[20] *Id.* at p. 6. The Boston Options Exchange (''BOX''), a trading facility of the Boston Stock Exchange, Incorporated (''BSE''), operates an auction known as the PIP, *see* Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (Order approving SR–BSE–2002–15 to establish trading rules for the BOX facility (''BOX Order'')), and the International Securities Exchange, Inc. (''ISE'') operates an auction known as the PIM, *see* Securities Exchange Act Release No. 50819 (December 8, 2004), 69 FR 75093 (December 15, 2004) (Order approving SR–ISE–2003–06 to adopt rules for the PIM).

[21] *See* Citadel Letter, *supra* note 6, at p.1.

[22] *See* Response Letter, *supra* note 7, at pp. 1–2.

[23] *See* BOX Letter, *supra* note 6, at pp. 4–5.

[24] *See* Response Letter, *supra* note 7, at pp. 4–5.

[25] CBOE Rule 6.9.

[26] CBOE Rule 4.1.

[27] *See also* ISE Rule 723(b)(1) and BOX Rules Chapter V, Sec. 18(e).

[28] *See* BOX Order, *supra* note 20.

[29] *See* BOX Letter, *supra* note 6, at p. 5.

the RFR on behalf of such orders.[30] In its Response Letter, the Exchange further explains that at the time customer orders are submitted to the member representing such orders, the member and the customer would discuss price improvement parameters, and the CBOE member representing customer orders would actually represent those customer orders during an AIM auction.[31] Based on the Exchange's representations, the Commission believes that public customer access to the AIM auction should be comparable to customers' access to open outcry auctions on the current floor-based exchanges.

D. Duration of the AIM

The CBOE proposes that the duration of each RFR period be for a random time period determined by the system that would not be less than 3 seconds and would not exceed 5 seconds.[32] The Commission believes that a RFR period between 3 and 5 seconds randomly determined by the Exchange's system should afford electronic crowds sufficient time to respond to, and compete for, Agency Orders submitted by an Initiating Member. The Commission expects that electronic systems should be readily available to CBOE members to allow them to respond to the RFR broadcasts.

E. Termination of Auction by Unrelated Orders

As proposed, the AIM would end prematurely under certain circumstances: [33] (1) If the Exchange Hybrid System receives an unrelated order in the same series as the Agency Order and such unrelated order is marketable against the Exchange's disseminated quote (when the quote is the NBBO) or the RFR responses; (2) if the Exchange Hybrid System receives an unrelated non-marketable 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 RFR response; (3) any time an RFR response matches the Exchange's disseminated quote on the opposite side of the market; or (4) pursuant to a pilot program that would expire on July 18, 2006, any time there is a market maker to market maker quote lock on the Exchange in accordance with CBOE Rule 6.45A(d).

BOX argues that the termination of the auction by an unrelated non-marketable limit order in the same series as the Agency Order and on the opposite side of the market could expose the AIM auction to manipulation. BOX believes the proposal is unclear as to why such orders should terminate the auction, unless they are for the full size of the Agency Order; BOX notes that other similar auction systems, such as the systems of BOX and ISE, treat such orders as price improvement orders and argues that categorizing such orders as price improvement orders would increase the number of RFR responses and maximize price improvement potential in the AIM auction.[34]

In the Response Letter, the Exchange asserts that both the unrelated non-marketable limit order and the Agency Order should be provided with price improvement (rather than the Agency Order only as provided in the BOX PIP and ISE PIM). The Exchange agreed with BOX that early termination of the auction for the purpose of manipulating the market would be inappropriate, and noted that according to proposed CBOE Rule 6.74.02, a pattern of submitting unrelated orders to end the auction prematurely would be a violation of Exchange rules and would be deemed conduct inconsistent with just and equitable principles of trade.[35]

The Commission believes that the treatment of unrelated non-marketable orders on the opposite side of the Agency Order is consistent with the requirements of the Act. The Exchange's proposal provides that the unrelated order and the Agency Order would receive price improvement, and the Commission believes that allowing both orders to be eligible for price improvement should benefit investors and customers. In addition, the Exchange's proposed interpretation would prohibit Exchange members from deliberately submitting orders to end the AIM auction prematurely. The Commission, however, expects the Exchange to analyze the impact of unrelated orders on the AIM auction to ensure that Agency Orders are not being deprived of a full opportunity for price improvement by the premature conclusion of an AIM auction.

F. Allocation at the Conclusion of the Auction

1. Order Matching Allocation Algorithms

At the conclusion of the auction, the Agency Order would be allocated in accordance with applicable matching algorithm rules in effect for such class subject to certain conditions.[36] BOX notes that proposed CBOE Rule 6.74A(b)(3) does not specify the matching algorithm as to how orders will be allocated,[37] and in its Response Letter, the Exchange has clarified that the matching algorithms are defined in CBOE Rule 6.45A for equity options and CBOE Rule 6.45B for index options.[38] The Commission believes that the matching algorithm set forth in these rules is sufficiently clear regarding how orders are to be allocated in the AIM auction.

2. Auto-Match

To initiate the electronic auction, the Initiating Member who represents an Agency Order would submit the Agency Order and also either specify a single-price submission to cross the Agency Order or indicate that it is willing to automatically match as principal the price and size of all auction responses (''Auto-Match''). If the Initiating Member uses the Auto-Match feature, the Initiating Member would not have control over the prices at which it receives an allocation of the Agency Order at the conclusion of the auction.

BOX, in its comment letter, argues that the Auto-Match feature of the AIM auction provides unfair competitive advantages to the Initiating Member. BOX contends that since the Exchange system governs the Auto-Match feature, it is likely to confer upon the Initiating Member a technological advantage in the sense that the Initiating Member would have the fastest response time to any competing RFR responses. BOX further contends that the proposal appears to provide the Initiating Member with an automatic ''last look'' at the best priced RFR response, thereby guaranteeing the Initiating Member an allocation in any auction. BOX also notes that RFR responses would not be visible to other AIM auction participants and believes that as a result, Exchange members would not

[30] *See* Amendment No. 2, *supra* note 5.

[31] *See* Response Letter, *supra* note 7, at p. 5.

[32] The AIM would end prior to the expiration of the RFR period under certain circumstances. *See* proposed CBOE Rule 6.74A(b)(2) and discussion in text accompanying notes 33–35.

[33] With respect to the same series, no AIM auction will run simultaneously with another AIM auction, nor will AIM auctions be permitted to queue or overlap in any manner. *See* proposed CBOE Rule 6.74A(b).

[34] *See* BOX Letter, *supra* note 6, at p. 3.

[35] *See* Response Letter, *supra* note 7, pp. 3–4.

[36] *See* proposed CBOE Rule 6.74A(b)(3). The Commission notes that to be consistent with the requirements of section 11(a) of the Exchange Act, 15 U.S.C. 78k(a), and Rule 11a1–1(T) under the Act, 17 CFR 240.11a1–1(T), Exchange Members must yield priority in the AIM auction to all non-Member orders, unless another exception to Section 11(a) applies.

[37] *See* BOX Letter, *supra* note 6, at p. 4.

[38] *See* Response Letter, *supra* note 7, at pp. 3–4.

have sufficient information to make a fully informed decision to compete for the Agency Order. Finally, BOX believes the ability of the Initiating Member to use Auto-Match would provide the Initiating Member an unfair advantage over customer orders and thus raise customer priority concerns.[39]

In its Response Letter, the Exchange states that a blind auction is a key component to AIM and that a blind auction would encourage participants to quote their best prices. The Exchange believes that in a blind auction, there is greater incentive for participants to submit their best prices at the outset, whereas in a non-blind auction, participants would need to submit only the minimal amount of improvement. Because AIM is a blind auction, the Exchange adds, it sought to propose a means by which the Initiating Member could still receive a guaranteed participation, *i.e.*, Auto-Match, similar to other mini-auctions, like BOX's PIP. CBOE notes that since PIP is not a blind auction, the initiating member could always configure its system to match the best response. Further, CBOE points out that under the terms of its proposal, when the Initiating Member selects Auto-Match prior to the start of the auction, the available liquidity would be doubled and pricing would be completely out of the Initiating Member's control. Finally, the Exchange states that BOX's argument that Auto-Match would provide the Initiating Member with some sort of technological advantage (in the form of faster response time) over other participants is misleading. The CBOE notes that once Auto-Match is selected (before the auction), the Initiating Member does not respond at all, but instead must honor the prices set forth in the responses received from other participants.[40]

The Commission believes that the Auto-Match feature of the AIM auction would not unfairly discriminate against other AIM participants. The Commission disagrees that a blind auction would necessarily deprive auction participants with information necessary to submit RFR responses. When the AIM system receives an Agency Order, the Exchange would submit a RFR to all participating members detailing the side and size of the Agency Order. RFR responses would not be visible to any of the auction participants, including the Initiating Member.

Finally, the Commission believes that an Initiating Member's use of Auto-Match would not have customer priority issues, since the proposal provides that public customer orders in the book must have priority.[41] At the same time, because the Auto-Match feature is offered only to the Initiating Member and would provide the Initiating Member with a guaranteed participation, the Commission believes it is essential that the Exchange provide data on the frequency of use of Auto-Match and its effect on price improvement to permit the Commission to monitor the impact of the proposed rule change on the competitive process.[42]

G. Price Improvement versus Facilitation

As discussed above, an Initiating Member who submits an Agency Order into the AIM auction must ''stop'' the Agency Order as follows: (1) If the Agency Order is for less than 50 contracts, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of (A) the NBBO price improved by one minimum price improvement increment, which increment shall be determined by the Exchange but may not be smaller than one cent or (B) the Agency Order's limit price (if the Agency Order is a limit order); or (2) if the Agency Order is for 50 contracts or more, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of the NBBO or the Agency Order's limit price (if the Agency Order is a limit order).[43]

BOX argues that the AIM rules should provide a minimum price improvement over the NBBO for orders of 50 contracts or greater. BOX noted that other auction systems such as ISE's PIM and BOX's PIP initiate auctions for such orders with a required price improvement of at least one cent better than the NBBO.[44] In response, the Exchange, however, points out that all of the options exchanges, other than BOX, allow guaranteed facilitation participation at the NBBO for orders of 50 contracts or greater.[45]

The Commission believes that stopping an Agency Order of 50 contracts or greater at the better of the NBBO or the Agency Order's limit price is consistent with the requirements of the Act. The Commission notes that it has approved rules of other options exchanges that permit facilitation at the NBBO for orders of 50 contracts or greater.[46] The Commission further notes that unlike the facilitation mechanisms of some exchanges, once the Initiating Member has submitted an Agency Order and designated a single-price submission or auto-match into the AIM auction, it may not modified or cancelled. Therefore, the Agency Order submitted to the AIM auction is guaranteed an execution price of at least the NBBO and, moreover, is given the opportunity for price improvement beyond the NBBO.

H. No Minimum Size Requirement for AIM

Like the BOX's PIP auction and the ISE's PIM auction, the AIM auction would be available for orders of fewer than 50 contracts. Under the Exchange's proposal, there would be no minimum size requirement for orders entered into the AIM, for a pilot period expiring on July 18, 2006.[47]

The Commission believes that the Exchange's proposal should provide small customer orders with the opportunity for price improvement, and is consistent with the Act. In particular, any Agency Order for less than 50 contracts that is entered into the AIM is guaranteed an execution at the end of the auction at a price at least a penny better than the NBBO. The Commission will evaluate the AIM auction during the Pilot Period to determine whether it would be beneficial to customers and to the options market as a whole to approve any proposal requesting permanent approval to permit orders of fewer than 50 contracts to be submitted to the AIM auction. In addition, the Commission will examine the data submitted by the Exchange with respect to situations in which the AIM auction is terminated prematurely by an unrelated order. To aid the Commission in its evaluation, the CBOE represents that it will provide the following information each month:

(1) The number of orders of fewer than 50 contracts entered into the AIM auction;

(2) The percentage of all orders of fewer than 50 contracts sent to CBOE that are entered into CBOE's AIM auction;

(3) The percentage of all CBOE trades represented by orders of fewer than 50 contracts;

(4) The percentage of all CBOE trades effected through the AIM auction

[39] *See* BOX Letter, *supra* note 6, at pp. 2, 5.

[40] *See* Response Letter, *supra* note 7, at pp. 2–3.

[41] *See* proposed CBOE rule 6.74A(b)(3)(B).

[42] *See* Section II.G.

[43] *See* proposed CBOE Rule 6.74A(a)(2) and (3).

[44] *See* BOX Letter, *supra* note 3.

[45] *See* Response Letter, *supra* note 7, at p. 4.

[46] *See e.g.,* Rule 6.47(b)(4) of the Pacific Exchange, Inc., ISE Rule 716(d).

[47] The July 18, 2006 pilot expiration date corresponds to the expiration of a similar pilot program for the BOX's PIP, and ISE's PIM. *See* BOX Rules, Chapter V, Sec. 18, Supplementary Material .01, and ISE Rule 723, Supplementary Material .03.

represented by orders of fewer than 50 contracts;

(5) The percentage of all contracts traded on CBOE represented by orders of fewer than 50 contracts;

(6) The percentage of all contracts effected through the AIM auction represented by orders of fewer than 50 contracts;

(7) The spread in the option, at the time an order of fewer than 50 contracts is submitted to the AIM auction;

(8) The number of orders of 50 contracts or greater entered into the AIM auction;

(9) The percentage of all orders of 50 contracts or greater sent to CBOE that are entered into CBOE's AIM auction;

(10) The spread in the option, at the time an order of 50 contracts or greater is submitted to the AIM auction;

(11) Of AIM trades for orders of fewer than 50 contracts, the percentage done at the NBBO plus $.01, plus $.02, plus $.03, etc.;

(12) Of AIM trades for orders of 50 contracts or greater, the percentage done at the NBBO plus $.01, plus $.02, plus $.03, etc.;

(13) The number of orders submitted by Exchange members when the spread was $.05, $.10, $.15, etc. For each spread, specify the percentage of contracts in orders of fewer than 50 contracts submitted to CBOE's AIM that were traded by: (a) the Exchange member that submitted the order to the AIM; (b) CBOE Market Makers assigned to the class; (c) other CBOE members; (d) Public Customer Orders; and (e) unrelated orders (orders in standard increments entered during the AIM auction). For each spread, also specify the percentage of contracts in orders of 50 contracts or greater submitted to CBOE's AIM that were traded by: (a) the Exchange member that submitted the order to the AIM; (b) CBOE Market Makers assigned to the class; (c) other CBOE members; (d) Public Customer Orders; and (e) unrelated orders (orders in standard increments entered during the AIM auction);

(14) The number of times that a market or marketable limit order in the same series on the same side of the market as the Agency Order prematurely ended the AIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the AIM auction that was terminated;

(15) The percentage of AIM early terminations due to the receipt of a market or marketable limit order in the same series on the same side of the market that occurred within a ½ second of the start of the AIM auction; the percentage that occurred within one second of the start of the AIM auction; the percentage that occurred within 1½ second of the start of the AIM auction; the percentage that occurred within 2 seconds of the start of the AIM auction; the percentage that occurred within 2½ seconds of the AIM auction; and the average amount of price improvement provided to the Agency Order where the AIM auction is terminated early at each of these time periods;

(16) The number of times that a market or marketable limit order in the same series on the opposite side of the market as the Agency Order prematurely ended the AIM auction and at what time the unrelated order ended the AIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the AIM auction that was terminated;

(17) The percentage of AIM auction early terminations due to the receipt of a market or marketable limit order in the same series on the opposite side of the market that occurred within a ½ second of the start of the AIM auction; the percentage that occurred within one second of the start of the AIM auction; the percentage that occurred within 1½ second of the start of the AIM auction; the percentage that occurred within 2 seconds of the start of the AIM auction; the percentage that occurred within 2½ seconds of the AIM auction; and the average amount of price improvement provided to the Agency Order where the AIM auction is terminated early at each of these time periods;

(18) The number of times that an RFR response matching the Exchange's disseminated quote on the opposite side of the market from the RFR responses prematurely ended the AIM auction and at what time the RFR response ended the AIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the AIM auction that was terminated;

(19) The percentage of AIM auction early terminations due to the receipt of an RFR response matching the Exchange's disseminated quote on the opposite side of the market from the RFR responses that occurred within a ½ second of the start of the AIM auction; the percentage that occurred within one second of the start of the AIM auction; the percentage that occurred within 1½ second of the start of the AIM auction; the percentage that occurred within 2 seconds of the start of the AIM auction; the percentage that occurred within 2½ seconds of the AIM auction; and the average amount of price improvement provided to the Agency Order where the AIM auction is terminated early at each of these time periods;

(20) The number of times that a quote lock on the Exchange pursuant to CBOE Rule 6.45A(d) prematurely ended the AIM auction and at what time the quote lock ended the AIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the AIM that was terminated;

(21) With respect to a quote lock on the Exchange pursuant to CBOE Rule 6.45A(d) that has occurred with an Agency Order to buy, the number of times that the quote was locked at the existing best bid and the number of times that the quote was locked at the existing best offer, and the firm that caused the quote lock;

(22) With respect to a quote lock on the Exchange pursuant to CBOE Rule 6.45A(d) that has occurred with an Agency Order to sell, the number of times that the quote was locked at the existing best bid and the number of times that the quote was locked at the existing best offer, and the firm that caused the quote lock;

(23) The frequency with which early termination due to a quote lock on the Exchange pursuant to CBOE Rule 6.45A(d) results in price improvement for the Agency Order; and the average amount of price improvement provided to the Agency Order;

(24) The average amount of price improvement provided to the Agency Order when the AIM auction is not terminated early (*i.e.*, runs the full three seconds); and

(25) The percentage of all CBOE trades effected through the AIM auction in which the Initiating Member has chosen the Auto-Match feature, and the average amount of price improvement provided to the Agency Order when the Initiating Member has chosen the Auto-Match feature vs. the average amount of price improvement provided to the Agency Order when the Initiating Member has chosen a single-price submission.

IV. Solicitation of Comments on Amendment No. 2

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2, including whether Amendment No. 2 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–2005–60 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–2005–60. 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 such 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–2005–60 and should be submitted on or before March 3, 2006.

V. Accelerated Approval of Amendment No. 2

The Commission finds good cause to approve Amendment No. 2 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the **Federal Register** pursuant to section 19(b)(2) of the Act.[48] The revisions made to the proposed rule change, as amended, in Amendment No. 2 clarified that Exchange members, when acting as agent for orders resting at the top of the Exchange's book on the other side of the Agency Order, may submit RFR responses on behalf of such orders. In addition, Amendment No. 2 clarified that the Exchange would submit certain data, as required by the Commission, during the Pilot Period and information submitted by the Exchange to the Commission would be on a confidential basis.

The Commission believes that the proposed changes in Amendment No. 2 are necessary to the proper functioning and implementation of AIM. The Commission believes that the proposed changes in Amendment No. 2 provide a clearer understanding of the operation of AIM and the Pilot Period and raise no new issues of regulatory concern. For these reasons, the Commission believes that accelerated approval of Amendment No. 2 is appropriate. Accordingly, pursuant to section 19(b)(2) of the Act,[49] the Commission finds good cause exists to approve Amendment No. 2 prior to the 30th day after notice of the Amendment is published in the **Federal Register**.

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with section 6(b)(5) of the Act.[50]

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[51] that the proposed rule change (SR–CBOE–2005–60) and Amendment No. 1 thereto, are approved, and that Amendment No. 2 thereto is approved on an accelerated basis, except that (1) paragraph (b)(2)(E) of CBOE Rule 6.74A is approved on a pilot basis until July 18, 2006; and (2) there shall be no minimum size requirement for orders entered into the AIM, for a pilot period expiring on July 18, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[52]

Jill M. Peterson,

Assistant Secretary.

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[48] 15 U.S.C. 78s(b)(2).

[49] 15 U.S.C. 78s(b)(2).

[50] 15 U.S.C. 78f(b)(5). In connection with the issuance of this approval order, neither the Commission nor its staff is granting any exemptive or no-action relief from the requirements of Rule 10b–10 under the Act. 17 CFR 240.10b–10. Accordingly, a broker-dealer executing a customer order through the AIM auction will need to comply with all applicable requirements of that Rule.

[51] 15 U.S.C. 78s(b)(2).

[52] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–53229; File No. SR–CBOE–2006–12]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Bid/Ask Differentials in CBOE Rule 8.7

February 6, 2006.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 31, 2006, 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 Exchange. The CBOE has filed this proposal pursuant to Section 19(b)(3)(A)(iii) of the Act [3] and Rule 19b–4(f)(6) thereunder,[4] which renders the proposal effective upon filing with the Commission.[5] 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 CBOE proposes to amend CBOE Rule 8.7, ''Obligations of Market Makers,'' to modify the bid/ask differential rules for options trading in open outcry and on the CBOE's Hybrid System (''Hybrid'') and Hybrid 2.0 Platform (''Hybrid 2.0'').[6] The text of the proposed rule change appears below. Proposed new language is *italicized;* proposed deletions are bracketed.

Rule 8.7—Obligations of Market-Makers

Rule 8.7. (a) No change

(b) Appointment. With respect to each class of option contracts for which he holds an Appointment under Rule 8.3, a Market-Maker has a continuous obligation to engage, to a reasonable

[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).

[5] The CBOE has asked the Commission to waive the five-day pre-filing requirement and the 30-day operative delay provided in Rule 19b–4(f)(6)(iii). 17 CFR 240.19b–4(f)(6)(iii).

[6] Hybrid is the CBOE's trading platform that allows individual Market Makers to submit electronic quotes in their appointed classes. Hybrid 2.0 is an enhanced trading platform that allows remote quoting by authorized categories of members. *See* CBOE Rule 1.1(aaa).