

All submissions should refer to File Number SR–NYSE–2009–80. 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 a.m. and 3 p.m. 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–NYSE–2009–80 and should be submitted on or before September 11, 2009.

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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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–60499; File No. SR–CBOE–2009–007]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Tied Hedge Transactions

August 13, 2009.

#### I. Introduction

On February 13, 2009, the Chicago Board Options Exchange, Incorporated

(“CBOE” or the “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 allow hedging stock, security futures, or futures contract positions to be represented currently with option facilitations or solicitations in the trading crowd (“tied hedge” orders). The proposed rule change was published for comment in the **Federal Register** on March 2, 2009.<sup>3</sup> The Commission received one comment letter on the proposal.<sup>4</sup> CBOE responded to the comment letter on August 11, 2009.<sup>5</sup> CBOE filed Amendment No. 1 to the proposed rule change on August 11, 2009. This notice and order provides notice of filing of Amendment No. 1 to the proposed rule change, and grants accelerated approval to the proposed rule change, as modified by Amendment No. 1.

#### II. Description of the Proposal

CBOE Rule 6.74 generally sets forth the procedures by which a floor broker may cross an order with a contra-side order. Transactions executed pursuant to Rule 6.74 are subject to the restrictions of paragraph (e) of Rule 6.9, *Solicited Transactions*, which prohibits trading based on knowledge of imminent undisclosed solicited transactions (commonly referred to as “anticipatory hedging”).

##### A. Anticipatory Hedging Rule

CBOE Rule 6.9, adopted in 1994, was originally designed to preserve the right to solicit orders in advance of submitting a proposed trade to the crowd, while at the same time assuring that orders that are the subject of a solicitation are exposed to the auction market in a meaningful way.<sup>6</sup> In

addition to requiring disclosure of orders and clarifying the priority principles applicable to solicited transactions, CBOE Rule 6.9 provides that it is inconsistent with just and equitable principles of trade for any member or associated person who has knowledge of all the material terms of an original order and a solicited order (including a facilitation order) that matches the original order's price to enter an order to buy or sell an option of the same class as any option that is the subject of the solicitation prior to the time the original order's terms are disclosed to the crowd or the execution of the solicited transaction can no longer reasonably be considered imminent. This prohibition extends to orders to buy or sell the underlying security or any “related instrument.”<sup>7</sup>

##### B. Proposed Exception to Anticipatory Hedging Rule

In order to address CBOE's perceived concerns associated with increased volatility and decreased liquidity and to more effectively compete with the over-the-counter market,<sup>8</sup> the Exchange is now proposing to adopt a limited exception to its anticipatory hedging restrictions that would permit the representation of hedging stock positions in conjunction with option orders, including complex orders, in the options trading crowd (a “tied hedge” transaction). The Exchange believes this limited exception would be consistent with the original design of CBOE Rule 6.9(e), but would set forth a more practicable approach that would facilitate hedging in today's trading environment while still encouraging meaningful competition among upstairs and floor traders.<sup>9</sup>

With a tied hedge transaction, Exchange members would be permitted to first hedge an option and then forward the option order and the hedging position to an Exchange floor broker with instructions to represent the option order together with the hedging position to the options trading crowd. Under the proposal, the original option order must be within designated size parameters, which would be determined by the Exchange and could not be smaller than 500 contracts. In addition, the original option order must be in a

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

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> See Securities Exchange Act Release No. 59435 (February 23, 2009), 74 FR 9115 (“Notice”).

<sup>4</sup> See Letter from Michael J. Simon, Secretary, International Securities Exchange, LLC (“ISE”), to Nancy M. Morris, Secretary, Commission dated March 25, 2009 (“ISE Letter”).

<sup>5</sup> See Letter from Jennifer M. Lamie, Assistant General Counsel, CBOE, to Elizabeth M. Murphy, Secretary, Commission dated August 11, 2009 (“CBOE Letter”).

<sup>6</sup> According to the Exchange, if the orders that comprise a solicited transaction are not suitably exposed to the order interaction process on the CBOE floor, the execution of such orders would not be consistent with CBOE rules designed to promote order interaction in an open-outcry auction. For example, CBOE Rule 6.43, *Manner of Bidding and Offering*, requires bids and offers to be made at the post by public outcry, and Rule 6.74 imposes specific order exposure requirements on floor brokers seeking to cross buy orders with sell orders. See Notice, *supra* note 3, at 9116.

<sup>7</sup> CBOE Rule 6.9(e) defines “related instrument” to mean “in reference to an index option, an order to buy or sell securities comprising ten percent or more of the component securities in the index or an order to buy or sell a futures contract on any economically equivalent index. With respect to an SPX option, an OEX option is a related instrument, and vice versa.”

<sup>8</sup> See Notice, *supra* note 3, at 9116 (discussing CBOE's rationale behind its proposal).

<sup>9</sup> See *id.* at 9120.

<sup>11</sup> 17 CFR 200.30–3(a)(12).

class designated as eligible for a tied hedge transaction. Eligible hedging positions would be determined by the Exchange for each eligible class and may include (i) the same underlying stock applicable to the option order, (ii) a security future overlying the same stock applicable to the option order, or (iii) in reference to an option on an index, exchange-traded fund (“ETF”), or options on HOLDing Company Depository Receipts (“HOLDRS”), a related instrument may be used as a hedge. A “related instrument” would mean, in reference to an index option, securities comprising ten percent or more of the component securities in the index or a futures contract on any economically equivalent index applicable to the option order. With respect to SPX, OEX would be an economically equivalent index, and vice versa.<sup>10</sup> A “related instrument” would mean, in reference to an ETF or HOLDRS option, a futures contract on any economically equivalent index applicable to the ETF or HOLDRS underlying the option order.<sup>11</sup>

The proposal would require that the entire hedging position, which could not exceed the options order on a delta basis, be brought without undue delay to the trading crowd, announced to the trading crowd concurrently with the option order, offered to the crowd in its entirety, and offered at the execution price received by the member or member organization introducing the order to any in-crowd market participant who has established parity or priority for the related options.

In-crowd market participants that participate in the option transaction must participate in the hedging position on a proportionate basis and would not be permitted to prevent the option transaction from occurring by giving a competing bid or offer for one component of the tied hedge order.

In addition, the proposal would require that, prior to entering tied hedge orders on behalf of customers, the member must deliver to the customer a one-time written notification informing the customer that its order may be executed using the Exchange’s tied hedge procedures. A member also would be required to create an electronic record of the tied hedge order

in a form and manner prescribed by the Exchange.

### C. Amendment No. 1

In Amendment No. 1, the Exchange reflected in rule text the priority treatment applicable to all tied hedge transactions (regardless of whether the original order is a simple order or a complex order) by clarifying that such transactions will be treated the same as complex orders for purposes of CBOE’s open outcry allocation and reporting procedures.<sup>12</sup> CBOE also clarified that where an original order is a simple order, the initial execution of the option leg will not qualify for the “complex trade” exception from the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (“Options Linkage Plan”).<sup>13</sup> The text of Amendment No. 1 is available on the Exchange’s Web site (<http://www.cboe.org/Legal>), at the Exchange’s Office of the Secretary, and at the Commission’s Public Reference Room.

### III. Summary of Comments and CBOE Response

The Commission received one comment on the proposed rule change from the ISE.<sup>14</sup> CBOE submitted a letter

<sup>12</sup> The Commission notes that, while a tied hedge may be treated the same as a complex order for purposes of CBOE’s intra-market priority, an original single-sided customer order would not otherwise constitute a complex order solely by virtue of being packaged into a tied hedge transaction. Accordingly, when a single-sided customer order is packaged into a tied hedge transaction, the execution of the option leg will not qualify for the “complex trade” exception from the Options Linkage Plan.

<sup>13</sup> On July 28, 2000, the Commission approved the Options Linkage Plan as a national market system plan for the purpose of creating and operating an intermarket options market linkage proposed by the American Stock Exchange LLC (n/k/a NYSE Amex LLC), CBOE, and International Securities Exchange, LLC (“ISE”). See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (File No. 4–429). Subsequently, Philadelphia Stock Exchange, Inc. (n/k/a NASDAQ OMX PHLX, Inc.), Pacific Exchange, Inc. (n/k/a NYSE Arca), Boston Stock Exchange, Inc. (n/k/a NASDAQ OMX BX, Inc.), and The NASDAQ Stock Market LLC joined the Options Linkage Plan. See Securities Exchange Act Release Nos. 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000) (File No. 4–429); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000) (File No. 4–429); 49198 (February 5, 2004), 69 FR 7029 (February 12, 2004) (File No. 4–429); and 57545 (March 21, 2008), 73 FR 16394 (March 27, 2008) (File No. 4–429). The Commission recently approved a new national market system plan regarding intermarket options linkage, the Options Order Protection and Locked/Crossed Market Plan, which carries over the complex order exception from the Options Linkage Plan. See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4–546). See also Securities Exchange Act Release No. 60187 (June 29, 2009), 74 FR 32664 (July 8, 2009) (SR–CBOE–2009–040) (notice of filing of CBOE’s new Options Linkage rules).

<sup>14</sup> See ISE Letter, *supra* note 4.

to the Commission responding to ISE’s comment letter.<sup>15</sup>

ISE argued that the proposed tied hedge transaction was similar to front-running and may disadvantage the trading crowd competing for the order in the auction process as well as the order being executed.<sup>16</sup> ISE believed that CBOE’s proposal would allow a member with knowledge of a pending transaction to have an advantage over others in the auction market process, which could result in less competition and worse prices for customers.<sup>17</sup>

In response, CBOE explained that it did not believe a firm that establishes a hedge position pursuant to the proposal would be taking advantage of material, nonpublic information as contemplated by the front-running prohibitions.<sup>18</sup> Rather, CBOE noted that its proposal provides the options trading crowd with the same access to a hedge as the solicited party, thereby allowing the crowd to compete on the same terms, because the tied hedge position would be required to be brought without undue delay to the trading crowd and announced concurrently with the option order, offered to the crowd in its entirety, and offered at the execution price received by the member to any in-crowd market participant who establishes parity or priority for the related option order.<sup>19</sup> The Exchange asserted its belief that the tied hedge proposal may result in narrow spreads and improved customer prices.<sup>20</sup>

In addition, ISE expressed concern that the proposed hedging activity may cause movement in the price of the underlying security and consequently the option, resulting in a worse price for the options customer.<sup>21</sup> In response, CBOE explained that its proposal attempts to address this concern by providing a mechanism to facilitate hedging that it believes will not be detrimental to the options orders being hedged nor the auction market.<sup>22</sup> CBOE noted that participants will continue to be governed by, among other things, their best execution responsibilities.

ISE further opined that CBOE’s proposal, because it does not permit the trading crowd to execute the options order without taking a proportionate share of the hedge, could increase internalization and lead to less vigorous

<sup>15</sup> See CBOE Letter, *supra* note 5.

<sup>16</sup> See ISE Letter, *supra* note 4, at 1.

<sup>17</sup> See *id.* at 1.

<sup>18</sup> See CBOE Letter, *supra* note 5, at 2–3.

<sup>19</sup> See *id.* at 3.

<sup>20</sup> See *id.* at note 5.

<sup>21</sup> See ISE Letter, *supra* note 4, at 1–2.

<sup>22</sup> See CBOE Letter, *supra* note 5, at 3.

<sup>10</sup> The proposed definition of a “related instrument” with respect to an index option is modeled after the definition that currently applies under Rule 6.9(e).

<sup>11</sup> For example, a tied hedge order involving options on the iShares Russell 2000 Index ETF might involve a hedge position in the underlying ETF, security futures overlying the ETF, or futures contracts overlying the Russell 2000 Index.

competition for price improvement.<sup>23</sup> ISE believed that requiring the crowd to take the hedge at the same price will prevent the crowd from giving the options customer the best price for its options transaction. In response, CBOE stated that the requirement to participate in the entire package is designed to keep the initiating member and in-crowd market participants on equal footing.<sup>24</sup> CBOE further argued that, since the trading crowd will have access to the same downside protection as the solicited party that executed the hedge position, the crowd should be willing to provide price improvement to the tied hedge order just as much as, if not more than, any other facilitation/solicited order.<sup>25</sup>

ISE also inquired whether CBOE's proposal would prohibit a firm from taking securities from inventory.<sup>26</sup> CBOE clarified that the tied hedge procedure would not permit a firm to take hedging securities from inventory and stated that, in contrast, the proposal explicitly requires that the hedge position be bought or sold following the receipt of an option order and prior to announcing such order in the trading crowd.<sup>27</sup>

ISE noted the possibility under CBOE's proposal that a customer order would not be executable because of market conditions in any of the non-CBOE markets in the underlying.<sup>28</sup> In response, CBOE noted that it recognized that market conditions in any of the non-CBOE market(s) may prevent the execution of the non-options leg(s) at the price(s) agreed upon. CBOE stated that in the event that the conditions in the non-CBOE market continue to prevent the execution of the non-option leg(s) at the agreed price(s), the trade representing the options leg(s) of the tied hedge transaction, as with any other complex order, may ultimately be cancelled in accordance with CBOE's existing rules.<sup>29</sup>

In addition, ISE expressed concern regarding the treatment of CBOE's tied-hedge transactions under the trade-through protections contained in the Options Linkage Plan as well as the contingent trade exemption under Regulation NMS.<sup>30</sup> ISE noted that tied-hedge transactions are not, by default, complex orders unless they meet the definition of a "complex trade" under

the uniform linkage rules. ISE also commented that tied hedge transactions in which the original customer order is a non-complex order for a single options series that it would not qualify for the qualified contingent trade exception to Rule 611(a) of Regulation NMS. ISE also opined that the exception for complex orders and exemption for qualified contingent trades require that the trades involve multiple legs for the same account, whereas a tied hedge would likely include components for multiple accounts of unrelated parties.

CBOE responded by noting that an in-crowd participant would be trading all legs of a tied hedge package like any other complex order, and, accordingly, it believes that contra-side executions would qualify as complex trades.<sup>31</sup> Further, in Amendment No. 1, CBOE clarified that where an original order is a simple order, the execution of the option leg will not qualify for the "complex trade" exception from the Options Linkage Plan.

Further, ISE stated its belief that a tied hedge differs from a complex order in that a stock-option order requires the stock leg to be on the opposite side of the options leg, whereas under CBOE's proposal the stock leg in the tied hedge transaction would be on the same side of the market as the options leg.<sup>32</sup> CBOE's response confirmed that under the proposal the stock leg of the tied hedge package would be on the opposite side from the option leg.<sup>33</sup>

ISE also argued that CBOE should explore further the mechanics of how tied hedge transactions would be executed on CBOE.<sup>34</sup> In particular, ISE inquired as to whether and how participants would execute the hedge in sub-penny increments. ISE also asked whether CBOE intended to impose any limit on who is permitted to participate in the auction for the order.<sup>35</sup>

CBOE responded that, as discussed in the Notice, tied hedge transactions would be treated the same as any other complex order with priority afforded in accordance with the Exchange's existing open outcry allocation and reporting procedures for complex orders.<sup>36</sup> In addition, CBOE stated that tied hedge transactions would also be subject to the existing national best bid or offer ("NBBO") trade-through requirements for options and stock, as applicable. CBOE noted that it discussed in the Notice that market conditions in any of

the non-CBOE markets may prevent the execution of the non-options leg(s) at the price(s) agreed upon and in such case the options leg(s) of the tied hedge transaction, as with any other complex order, may ultimately be cancelled in accordance with CBOE's existing rules.<sup>37</sup> CBOE further explained that in scenarios where the hedge would result in a net sub-penny price, the hedge would be executed with orders at multiple price points necessary to receive the same overall net price in much the same manner that the original stock hedge was obtained.<sup>38</sup>

#### IV. Discussion

After careful review of the proposed rule change, as amended, the comment letter, and CBOE's response to the comment letter, 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.<sup>39</sup> In particular, the proposal is consistent with Section 6(b)(5) of the Act,<sup>40</sup> 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, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Further, the Commission believes that CBOE has sufficiently responded to the issues raised by the ISE in its comment letter.

In the Notice, CBOE justified its proposal by explaining that changes in the marketplace have caused it to re-evaluate the effectiveness and efficiency of its anticipatory hedging rule, as well as its previous objections to an exception proposed by another exchange for its proposed equivalent rule in 2003.<sup>41</sup> When the prohibition on

<sup>37</sup> See *id.*

<sup>38</sup> See *id.*

<sup>39</sup> In approving this rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>40</sup> 15 U.S.C. 78f(b)(5).

<sup>41</sup> CBOE's proposed exception is similar to an exception that had been proposed in 2003 by the Philadelphia Stock Exchange ("Phlx"). See Securities Exchange Act Release No. 48875 (December 4, 2003), 68 FR 70072 (December 16, 2003) (SR-Phlx-2003-75). At the time of the Phlx proposal, which was withdrawn, CBOE commented that the proposal should not be approved unless certain amendments were made. For example, CBOE suggested that the tied hedge procedures should be limited to scenarios where the order cannot be satisfied by the displayed national best

<sup>23</sup> See ISE Letter, *supra* note 4, at 2.

<sup>24</sup> See CBOE Letter, *supra* note 5, at 3.

<sup>25</sup> See *id.*

<sup>26</sup> ISE Letter, *supra* note 4, at 2.

<sup>27</sup> See CBOE Letter, *supra* note 5, at 3.

<sup>28</sup> See ISE Letter, *supra* note 4, at 2.

<sup>29</sup> See CBOE Letter, *supra* note 5, at 6.

<sup>30</sup> See ISE Letter, *supra* note 4, at 3.

<sup>31</sup> See CBOE Letter, *supra* note 5, at 4.

<sup>32</sup> See ISE Letter, *supra* note 4, at 3.

<sup>33</sup> See CBOE Letter, *supra* note 5, at 5.

<sup>34</sup> See ISE Letter, *supra* note 4, at 3.

<sup>35</sup> See *id.* at 4.

<sup>36</sup> See CBOE Letter, *supra* note 5, at 5.

anticipatory hedging was originally adopted, CBOE believed that it was necessary to prevent members and associated persons from using undisclosed information about imminent solicited option transactions to trade the relevant option or any closely-related instrument in advance of persons represented in the relevant options crowd. The Exchange now believes that increased volatility in the markets, as well as the advent of penny trading in underlying stocks and resultant decreased liquidity at the top of each underlying market's displayed national best bid or offer, has made it increasingly difficult for members and member organizations to assess ultimate execution prices and the extent of available stock to hedge related options facilitation/solicitation activities, and to manage that market risk.<sup>42</sup> These circumstances may make it more difficult to obtain a hedge, to quote orders, and to achieve executions. In addition, the Exchange believes that market-makers' trading strategies have evolved to focus less on delta risk and more on volatility.<sup>43</sup> The proposed tied hedge transaction procedures are intended to reflect CBOE's perceived shift by members toward a volatility trading strategy, and to make it more desirable for market makers to compete for orders that are exposed through the solicitation process. The Exchange further expects its proposal to allow members to hedge an original order and thus minimize delta risk and, thus, should provide an opportunity for members to provide customers with tighter quotes to the extent they are able to use the tied hedge procedure to better hedge and compete for orders.<sup>44</sup>

**Minimum Size.** Under the proposal, the original option order must be within designated tied hedge eligibility size parameters, which could not be smaller than 500 contracts.<sup>45</sup> The minimum order size would apply to an individual

bid or offer ("NBBO") or, for similar reasons, the order is of a significantly larger than average size. See letters from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated January 14, 2004 ("CBOE Letter I") and May 20, 2004 ("CBOE Letter II").

<sup>42</sup> See Notice, *supra* note 3, at 9116.

<sup>43</sup> See *id.* at 9116-17.

<sup>44</sup> See *id.* at 9119.

<sup>45</sup> The designated classes and minimum order size applicable to each class would be communicated to the membership via Regulatory Circular. For example, the Exchange could determine to make the tied hedge transaction procedures available in options class XYZ for orders of 1000 contracts or more. Such a determination would be announced via Regulatory Circular, which would include a cumulative list of all classes and corresponding sizes for which the tied hedge procedures are available.

original order, and multiple original orders could not be aggregated to satisfy the requirement.<sup>46</sup> The Commission believes that this requirement is reasonable and should limit use of the tied hedge procedures to institutional customers who are in a better position to understand the mechanics of the process and who may benefit from the ability to execute a facilitating hedge on CBOE.<sup>47</sup>

**Written Notification.** The proposal also requires that, prior to entering tied hedge orders on behalf of customers, the CBOE member must deliver to its customer a one-time written notification informing the customer that his order may be executed using the Exchange's tied hedge procedures and disclosing the terms and conditions contained in the proposed rule. Given the minimum size requirement of 500 contracts per order, the Exchange believes that use of the tied hedge procedures will generally consist of orders for the accounts of institutional or sophisticated, high net worth investors.<sup>48</sup> Given the target audience and the considerable minimum size requirement, the Commission believes that a one-time notification is sufficient and is consistent with similar notification requirements on other exchanges.<sup>49</sup>

**Eligible Hedging Positions.** The proposed rule would require that the hedging position associated with the tied hedge order be composed of a position that is designated as eligible for a tied hedge transaction. Eligible hedging positions would be determined by the Exchange for each eligible class

<sup>46</sup> In determining whether an individual original order satisfies the eligible order size requirement, any complex order must contain one leg alone that is for the eligible order size or greater. This approach to the eligible order size requirement for complex orders is analogous to Rule 6.74(d)(iii), which provides that a complex order must contain one leg alone that is for the eligible order size or greater to be eligible for an open outcry crossing entitlement.

<sup>47</sup> As discussed above *supra* note 41, in commenting on the prior Phlx proposal, CBOE suggested that the tied hedge procedures be limited to scenarios where the order cannot be satisfied by the NBBO or, for similar reasons, the order is of a significantly larger than average size. CBOE's reasoning was that there may not be as much benefit to delaying the representation and execution of smaller orders that may be immediately fillable or executed more quickly by sending an order to the options crowd (as opposed to tying up such an order with stock). See CBOE Letter II, *supra* note 41, at 3-4. The Exchange now believes the decreased liquidity available at the NBBO, the frequency with which quotes may flicker, and differing costs associated with accessing liquidity on various markets, as well as for ease of administration, that its proposed 500 contract minimum is sufficient to address these considerations. See Notice, *supra* note 3, at 9117.

<sup>48</sup> See Notice, *supra* note 3, at 9117.

<sup>49</sup> See ISE Rule 716(e)(3) (Solicited Order Mechanism).

and may include (i) the same underlying stock applicable to the option order, (ii) a security future overlying the same stock applicable to the option order, or (iii) in reference to an option on an index, ETF or HOLDRS, a "related instrument" (as described above). For example, for options overlying XYZ stock, the Exchange may determine to designate the underlying XYZ stock or XYZ security futures or both as eligible hedging positions.<sup>50</sup> The Commission believes that this provision will provide for a definitive hedge that is easily understood by other market participants, and consequently should allow members who may be considering participating in a tied hedge order to evaluate more readily the risk associated with the option in light of the hedge.

**Presentation to the Crowd.** The proposal would require that the entire hedging position be brought promptly and without "undue delay" to the trading crowd. In addition, the proposal would require that the hedging position be announced to the trading crowd concurrently with the option order, offered to the crowd in its entirety, and offered at the execution price received by the member or member organization introducing the order to any in-crowd market participant who has established parity or priority for the related options. In-crowd market participants that participate in the option transaction would be required to participate in the hedging position on a proportionate basis<sup>51</sup> and would not be permitted to prevent the option transaction from occurring by giving a competing bid or offer for one component of the tied hedge order. The Commission believes that these requirements are reasonably designed to encourage access to and participation by the trading crowd in the tied hedge transaction.

Further, while delta estimates may vary slightly, the introducing member would be required to assume a hedging position that does not exceed the equivalent size of the options order on a delta basis.<sup>52</sup> For example, with a tied

<sup>50</sup> As with designated classes and minimum order size, the eligible hedging positions applicable to each class would be communicated to the membership via Regulatory Circular, which would include a cumulative list of all classes and corresponding sizes for which the tied hedge procedures are available.

<sup>51</sup> For example, if an in-crowd market participant's allocation is 100 contracts out of a 500 contract option order (1/5), the same in-crowd market participant would trade 10,000 shares of a 50,000 stock hedge position tied to that option order (1/5).

<sup>52</sup> In the Notice, the Exchange notes that there may be scenarios where the introducing member purchases (sells) less than the delta, e.g., when there is not enough stock is available to buy (sell)

hedge transaction involving the purchase of 50,000 shares of XYZ stock and the sale of 100 XYZ call contracts with a delta of 100, the order would be considered fully hedged by 50,000 shares of stock. The Commission believes that prohibiting a tied hedge order from being deliberately over-hedged should ensure that such transactions represent bona fide hedging activity and should not deter the willingness of the options crowd to participate in the order.

*Priority.* The Exchange has not proposed any special priority provisions applicable to tied hedge transactions. Tied hedge transactions would be treated the same as complex orders (regardless of whether the original order was a simple or complex order) for purposes of CBOE's intra-market priority.<sup>53</sup> The Commission notes that while an original single-sided customer order would not constitute a complex order, particularly for purposes of the complex trade exception to the Options Linkage Plan, CBOE's proposal to treat such order when it is packaged into a tied hedge transaction the same as a complex order for the limited purpose of determining CBOE's intra-market priority is reasonable. Among other

at the desired price. In such scenarios, the introducing member would present the stock that was purchased (sold) and share it with the in-crowd market participants on equal terms. This risk of obtaining less than a delta hedge is a risk that exists under the current rules because of the uncertainty that exists when market participants price an option and have to anticipate the price at which they will be able to obtain a hedge. The proposed tied hedge procedures are designed to help reduce this risk, but the initiating member may still be unable to execute enough stock at the desired price. See Notice, *supra* note 3, at 9118.

<sup>53</sup> Generally, a complex order may be expressed in any increment and executed at a net debit or credit price with another member without giving priority to equivalent bids (offers) in the individual series legs that are represented in the trading crowd or in the public customer options limit order book provided at least one leg of the order betters the corresponding bid (offer) in the public customer options limit order book. For stock-option orders and security future-option orders, this means that the options leg of the order has priority over bids (offers) of the trading crowd but not over bids (offers) in the public customer options limit order book. In addition, for complex orders with non-option leg(s), such as stock-option orders, a bid or offer is made and accepted subject to certain other conditions, including that the options leg(s) may be cancelled at the request of any member that is a party to the transaction if market conditions in any non-CBOE market(s) prevent the execution of the non-options leg(s) at the agreed price(s). See, e.g., CBOE Rules 6.42, *Minimum Increments for Bids and Offers*, 6.45, *Priority of Bids and Offers—Allocation of Trades*, 6.45A(b), *Allocation of Orders Represented in Open Outcry* (for equity options), 6.45B(b), *Allocation of Orders Represented in Open Outcry* (for index options and options on ETFs), 6.48, *Contract Made on Acceptance of Bid or Offer*, and 6.74. Any crossing participation entitlement would also apply to the tied hedge procedures in accordance with Rule 6.74(d).

things, because a tied hedge transaction would be presented to the crowd as a package and crowd participants could only trade with both the order and the hedge on a proportionate basis, such treatment is appropriate under the circumstances with respect to CBOE's intra-market priority.

To the extent applicable and available, tied hedge transactions may also qualify for existing NBBO trade-through exceptions for options and stock, including, for example, the complex trade exception to the Options Linkage Plan (which would apply when the original order is a complex order)<sup>54</sup> and the qualified contingent trade exception to Rule 611(a) for the stock component when an in-crowd participant participates in the transaction.<sup>55</sup>

<sup>54</sup> Where the original order is a simple order, the execution of the option leg will not qualify for the "complex trade" exception from the Options Linkage Plan. Thus, a member could not tie a customer single-sided options order to a hedging position for the sole purpose of availing the tied hedge package to the complex trade exception from the Options Linkage Plan. A "complex trade" is defined as: (i) The execution of an order in an option series in conjunction with the execution of one or more related orders in different option series in the same underlying security occurring at or near the same time in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.0) and for the purpose of executing a particular investment strategy; or (ii) the execution of a stock option order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock ("convertible security") coupled with the purchase or sale of option contract(s) on the opposite side of the market representing either (A) the same number of units of the underlying stock or convertible security, or (B) the number of units of the underlying stock or convertible security necessary to create a delta neutral position, but in no case in a ratio greater than 8 option contracts per unit of trading of the underlying stock or convertible security established for that series by the Options Clearing Corporation. See paragraph (4) of CBOE Rule 6.80, *Definitions* (applicable to Options Linkage), and subparagraph (b)(7) to CBOE Rule 6.83, *Order Protection*. The new Options Linkage Plan was recently approved by the Commission and carries over the complex order exception. See Securities Exchange Act Release No. 60405 (July 30, 2009) (File No. 4-546). See also Securities Exchange Act Release No. 60187 (June 29, 2009), 74 FR 32664 (July 8, 2009) (notice of filing of CBOE's new Options Linkage rules).

<sup>55</sup> A "qualified contingent trade" is defined as a transaction consisting of two or more component orders, executed as agent or principal, where: (i) At least one component order is in an NMS stock; (ii) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent; (iii) the execution of one component is contingent upon the execution of all other components at or near the same time; (iv) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed; (v) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge

Further, when a tied hedge transaction is executed, it is possible that market conditions in a non-CBOE market might prevent the execution of the non-options leg(s) at the price(s) agreed upon. In this event, the trade representing the options leg(s) of the tied hedge transaction may ultimately be cancelled in accordance with CBOE's existing rules.<sup>56</sup>

The following example, which CBOE included in the Notice,<sup>57</sup> illustrates the mechanics of a tied hedge transaction:

- The CBOE member initiates a tied hedge based on either a simple or complex original customer order. For example, in a *simple original order*, the introducing member receives a customer order to buy 500 XYZ call options, which has a delta of 100. The introducing member then purchases 50,000 shares of XYZ stock on the NYSE for an average price of \$25.03 per share. Once the stock is executed on the NYSE, the introducing member, without undue delay, announces the 500 contract option order along with the 50,000 share tied stock hedge at \$25.03 per share to the CBOE trading crowd. For a *complex original order*, the introducing member receives a customer stock-option order to buy 500 XYZ call options and sell 50,000 shares of XYZ stock. The introducing member purchases 50,000 shares of XYZ stock on the NYSE for an average price of \$25.03 per share. Once the stock is executed on the NYSE, the introducing member, without undue delay, announces the tied hedge package to the trading crowd.

- The in-crowd market participants would have an opportunity to provide competing quotes for the tied hedge package (but not for the individual component legs of the package).

- The option order and hedging stock would be allocated among the in-crowd market participants that established priority or parity at that price, including the initiating member, in accordance with the allocation algorithm applicable to the options class, with the options leg being executed and reported on CBOE and the stock leg being executed and

that have been announced or since cancelled; and (vi) any trade-throughs caused by the execution of an order involving one or more NMS stocks (each an "Exempted NMS Stock Transaction") is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade. See Securities Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008).

<sup>56</sup> See paragraph (b) to CBOE Rule 6.48. The Exchange notes that, in the event of a cancellation, members may be exposed to the risk associated with holding the hedge position.

<sup>57</sup> See Notice, *supra* note 3, at 9119–20.

reported on the stock market specified by the initiating member.<sup>58</sup>

- The execution of the options leg would have to satisfy CBOE's intra-market priority rules for complex orders (including that the execution price may not be outside the CBOE BBO).

- Where the customer order is a complex order (not a simple order), the tied hedge transaction may qualify as a "complex trade" under the Options Linkage Plan in which case the execution of the 500 option contracts with the market participants would not be subject to the NBBO for the particular option series.

- If the crowd participates in the tied hedge transaction, the equities portion of the trade may qualify as a "qualified contingent trade" under Regulation NMS. For example, if the crowd takes an equivalent share representing 20,000 shares of stock (from the original 50,000 shares), the market participants would not be subject to the NBBO for the 20,000 shares of underlying XYZ stock that they execute.

- The execution of stock would have to satisfy the intra-market priority rules of the non-CBOE market(s) where the stock is to be executed.

The Commission believes that CBOE has adequately described the mechanics of a proposed tied hedge order, and that the priority treatment afforded to a tied hedge transaction is appropriate and consistent with CBOE's existing priority rules.

#### V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>59</sup> for approving the proposed rule change, as modified by Amendment No. 1, prior to the thirtieth day after publication of notice of filing of Amendment No. 1 in the **Federal Register**. In Amendment No. 1, the Exchange revised the proposed rule text to clarify that all tied hedge transactions (regardless of whether the original order was a simple order or a complex order such as a spread, straddle, combination, or stock-option order) will be treated as complex for purposes of CBOE's open outcry allocation and reporting

<sup>58</sup> For example, the introducing member might trade 40% pursuant to an open outcry crossing entitlement (200 options contracts and 20,000 shares of stock) and the remaining balance might be with three different market makers that each participated on 20% of the order (100 options contracts and 10,000 shares of stock per market maker).

<sup>59</sup> 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

procedures. This treatment of tied hedge transactions was described by CBOE in the Notice.<sup>60</sup> CBOE now proposes to reflect this priority provision in the rule text for the sake of clarity.

CBOE also specified in the proposed rule text that the option and stock legs of a tied hedge transaction may qualify for various NBBO trade-through exceptions but, where the original order is a simple order, the execution of the option leg will not qualify for the "complex trade" exception from the Options Linkage Plan.<sup>61</sup> Accordingly, to the extent that a single-sided customer order was packaged to create a tied hedge transaction, such tied hedge would not qualify as a complex order for purposes of the Options Linkage Plan.

The changes proposed in Amendment No. 1, discussed above, seek to clarify the operation of the proposal, particularly with respect to the priority rules applicable to a tied hedge transaction, and do not differ materially from the proposal as noticed in the **Federal Register** on March 2, 2009. Accordingly, the Commission finds that good cause exists to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

#### VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether Amendment No. 1 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 No. SR-CBOE-2009-007 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2009-007. This file number should be included on the

<sup>60</sup> See Notice, *supra* note 3, at 9119.

<sup>61</sup> This description by CBOE represents a change from the Notice, in which CBOE indicated all tied hedge transactions (regardless of whether the original order was a simple or complex order) would be treated as complex orders, and thus may qualify for the complex trade exception to the Options Linkage Plan. See Amendment No. 1.

subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, on official business days between the hours of 10 a.m. and 3 p.m. 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-2009-007 and should be submitted on or before September 11, 2009.

#### VII. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>62</sup> that the proposed rule change (SR-CBOE-2009-007), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>63</sup>

**Florence E. Harmon,**  
*Deputy Secretary.*

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<sup>62</sup> 15 U.S.C. 78s(b)(2).

<sup>63</sup> 17 CFR 200.30-3(a)(12).