

does not normally weaken the plan's contribution base. For that reason, Congress established special withdrawal rules for the construction and entertainment industries.

For construction industry plans and employers, section 4203(b)(2) of ERISA provides that a complete withdrawal occurs only if an employer ceases to have an obligation to contribute under a plan, and the employer either continues to perform previously covered work in the jurisdiction of the collective bargaining agreement or resumes such work within five years without renewing the obligation to contribute at the time of resumption. Section 4203(c)(1) of ERISA applies the same special definition of complete withdrawal to the entertainment industry, except that the pertinent jurisdiction is the jurisdiction of the plan rather than the jurisdiction of the collective bargaining agreement. In contrast, the general definition of complete withdrawal in section 4203(a) of ERISA defines a withdrawal to include permanent cessation of the obligation to contribute regardless of the continued activities of the withdrawn employer.

Congress also established special partial withdrawal liability rules for the construction and entertainment industries. Under section 4208(d)(1) of ERISA, "[a]n employer to whom section 4203(b) (relating to the building and construction industry) applies is liable for a partial withdrawal only if the employer's obligation to contribute under the plan is continued for no more than an insubstantial portion of its work in the craft and area jurisdiction of the collective bargaining agreement of the type for which contributions are required." Under section 4208(d)(2) of ERISA, "[a]n employer to whom section 4203(c) (relating to the entertainment industry) applies shall have no liability for a partial withdrawal except under the conditions and to the extent prescribed by the [PBGC] by regulation."

Section 4203(f) of ERISA provides that the PBGC may prescribe regulations under which plans in other industries may be amended to provide for special withdrawal liability rules similar to the rules prescribed in section 4203(b) and (c) of ERISA. Section 4203(f)(2) of ERISA provides that such regulations shall permit the use of special withdrawal liability rules only in industries (or portions thereof) in which the PBGC determines that the characteristics that would make use of such rules appropriate are clearly shown, and that the use of such rules would not pose a significant risk to the

insurance system under Title IV of ERISA. Section 4208(e)(3) of ERISA provides that the PBGC shall prescribe by regulation a procedure by which plans may be amended to adopt special partial withdrawal liability rules upon a finding by the PBGC that the adoption of such rules is consistent with the purposes of Title IV of ERISA.

The PBGC's regulation, *Extension of Special Withdrawal Liability Rules* (29 CFR part 4203), prescribes procedures whereby a multiemployer plan may ask PBGC to approve a plan amendment that establishes special complete or partial withdrawal liability rules. The regulation may be accessed on the PBGC's Web site (<http://www.pbgc.gov>).

#### Request

The PBGC has received a request from the Service Employees International Union Local 1 Pension Trust Fund ("Local 1 Plan") for approval of a plan amendment providing for special withdrawal liability rules. A copy of the originating request, and PBGC's summary of the actuarial reports that the plan provided, may be accessed on the PBGC's Web site (<http://www.pbgc.gov>). A copy of the complete filing may be requested from the PBGC Disclosure Officer. The fax number is 202-326-4042. It may also be obtained by writing the Communications and Public Affairs Department, PBGC, 1200 K Street, NW., Suite 1200, Washington, DC 20005.

In brief, the Local 1 Plan, a multiemployer plan covering the residential building cleaning industry in Chicago, represents that the industry has characteristics similar to those of the construction industry. The plan has adopted an amendment prescribing special withdrawal liability rules, which, if approved by the PBGC, would be effective as of July 1, 2005. Under the proposed amendment, complete withdrawal of an employer would occur only under conditions similar to those described in ERISA section 4203(b)(2), or certain other conditions including a mass withdrawal. Partial withdrawal of an employer would occur only under conditions similar to those described in ERISA section 4208(d)(1). The request includes actuarial data to support the plan's contention that the amendment will not pose a significant risk to the insurance system under Title IV of ERISA.

#### Comments

All interested persons are invited to submit written comments concerning the pending request to the PBGC at the above address by April 16, 2009. All comments will be made a part of the

record. Comments received will be available for public inspection at the address set forth above.

Issued in Washington, DC, on this 17th day of February, 2009.

**Vincent K. Snowbarger,**

*Acting Director, Pension Benefit Guaranty Corporation.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-59435; File No. SR-CBOE-2009-007]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change Relating to Tied Hedge Transactions

February 23, 2009.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 13, 2009, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt Interpretation and Policy .10 to Rule 6.74, *Crossing Orders*, to allow hedging stock, security future or futures contract positions to be represented currently with option facilitations or solicitations in the trading crowd ("tied hedge" orders). The text of the proposed rule change is available on the Exchange's Web site (<http://www.cboe.org/Legal>), at the Office of the Secretary, CBOE and at the Commission.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed

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

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

rule change. The text of these statements may be examined at the places specified in Item IV below. CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

*A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

1. Purpose

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").

Existing Anticipatory Hedge Rule

By way of background, when Rule 6.9 was adopted in 1994, the Exchange noted its belief that it is appropriate to permit solicitation between potential buyers and sellers of options in advance of the time they send actual orders to the trading crowd on the Exchange. The Exchange also noted that complex orders, such as spreads, straddles, combination and stock-option orders, often require the "advance shopping" that is characteristic of a solicited transaction, and that such interactions between buyers and sellers and the resulting solicited transactions can enhance liquidity and depth at the CBOE by bringing orders to the floor that might otherwise be difficult to effect. While recognizing this, Exchange also noted that, 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.<sup>3</sup> Solicited transactions by definition entail negotiation, and if the orders that comprise a solicited transaction are not adequately exposed to the floor auction, the in-crowd market participants (e.g., Market-Makers in the trading crowd) cannot have sufficient time to digest and react to those orders' terms. The pre-negotiation inherent in the solicitation process thus can enable the parties to a solicited transaction to preempt the crowd to an execution at

the pre-negotiated price. Thus, the Exchange notes, Rule 6.9 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. In addition to requiring disclosure of orders and clarifying the priority principles applicable to solicited transactions,<sup>4</sup> 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<sup>5</sup> 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," as that term is defined in the rule.<sup>6</sup>

When originally adopted in 1994, the CBOE believed that the prohibition on anticipatory hedging 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. CBOE believes the basic principle remains true today, but changes in the marketplace have caused CBOE to re-evaluate the

effectiveness and efficiency of CBOE's existing rule's procedural requirements, as well as CBOE's previous objections to an exception proposed by another exchange for its proposed equivalent rule in 2003.<sup>7</sup> Since that time, the Exchange 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, it has become 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. This risk extends to simple and complex orders, and to all market participants involved in the transaction (whether upstairs or on-floor) because of the uncertainty of the extent to which the market participant will participate in the transaction, the amount of time associated with the auction process, and the likelihood that the underlying stock prices in today's environment may be difficult to assess and change before they are able to hedge. These circumstances make it difficult to obtain a hedge, difficult to quote orders and difficult to achieve executions, and can translate into less liquidity in the form of smaller size and wider quote spreads, fewer opportunities for price improvement, and the inefficient handling of orders. Additionally, more and more trading activity appears to be taking place away from the exchange-listed environment and in the over-the-counter ("OTC") market, which by its nature is not subject to the same trade-through type risks present in the exchange environment. Therefore, the Exchange is seeking to make its trading rules more efficient not only to address the market risk and execution concerns, but also to effectively compete with and attract volume from the OTC market. What is more, Market-Makers' trading strategies have evolved. Whereas before

<sup>4</sup> For example, the rule requires that the member or member organization representing an original order that is the subject of a solicitation to disclose the terms of the original order to the crowd before the original order can be executed. This disclosure is intended to eliminate the unfairness that can be associated with pre-negotiated transactions among the parties to the solicitation versus the in-crowd market participants, and would subject the order that is the subject of the solicitation to full auction interaction with other orders in the crowd. In addition, priority is accorded depending on whether the original order is disclosed throughout the solicitation period; whether the solicited order improves the best bid or offer in the trading crowd; and whether the solicited order matches the original order's limit. Rule 6.74(d) contains exceptions to these priority provisions in instances where a crossing participation entitlement is sought.

<sup>5</sup> An "original order" is an order respecting an option traded on the Exchange, including a spread, combination, straddle, stock option, security-future-option or any other complex order. See Rule 6.9.

<sup>6</sup> For purposes of Rule 6.9(e), an order to buy or sell a "related instrument," means, "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>3</sup> For example, 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.

<sup>7</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 ultimately not pursued to approval, 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 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 and May 20, 2004; see also note 15, *infra*.

Market-Makers tended to trade based on delta risk,<sup>8</sup> now market-making strategy is based more on volatility.<sup>9</sup> The tied hedge transaction procedures (described below) are designed in a way that is consistent with this shift toward a volatility trading strategy, and makes it more desirable for Market-Makers to compete for orders that are exposed through the solicitation process.

In order to address the concerns associated with increased volatility and decreased liquidity and more effectively compete with the OTC market, the Exchange is proposing to adopt a limited exception to the 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 remains in keeping with the original design of Rule 6.9(e), but sets forth a more practicable approach considering today’s trading environment that will provide the ability to hedge in a way that will still encourage meaningful competition among upstairs and floor traders. Besides stock positions, the proposal would also permit security futures positions to be used as a hedge. In addition, in the case where the order is for options on indices, options on exchange-traded funds (“ETF”) or options on HOLDing Company Depository Receipts (“HOLDERS”), 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 HOLDR option, a futures contract on any economically equivalent index applicable to the ETF or HOLDR underlying the option order.<sup>11</sup>

With a tied hedge transaction, Exchange members would be permitted to first hedge an option order with the underlying security, a security future or futures contract, as applicable, 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. The in-crowd market participants that chose to participate in the option transaction must also participate in the hedging position. First, under the proposal, the original option order must be in a class designated as eligible for a tied hedge transaction as determined by the Exchange, including FLEX Options classes.<sup>12</sup> The original option order must also be within designated tied hedge eligibility size parameters, which would be determined by the Exchange and would not be smaller than 500 contracts.<sup>13</sup> The Exchange notes that the minimum order size would apply to an individual original order.<sup>14</sup> Multiple original orders could not be aggregated to satisfy the requirement (though multiple contra-

side solicited orders could be aggregated to execute against the original order). The Exchange states that the primary purpose of this provision is to limit use of the tied hedge procedures to larger orders that might benefit from a member’s or member organization’s ability to execute a facilitating hedge.<sup>15</sup> Assuming an option order meets these eligibility parameters, the proposal also includes a number of other conditions that must be satisfied.

Second, the proposal would also require that, prior to entering tied hedge orders on behalf of customers, the member or member organization must deliver to the customer a one-time written notification informing the customer that his order may be executed using the Exchange’s tied hedge procedures. Under the proposal, the written notification must disclose the terms and conditions contained in the proposed rule and be in a form approved by the Exchange. Given the minimum size requirement of 500 contracts per order, the Exchange believes that use of the tied hedges procedures will generally consist of orders for the accounts of institutional or sophisticated, high net worth investors. The Exchange therefore believes that a one-time notification delivered by the member or member organization to the customer would be sufficient, and that an order-by-order notification would be unnecessary and overly burdensome.

Third, a member or member organization would be required to create an electronic record that it is engaging in a tied hedge order in a form and manner prescribed by the Exchange. The Exchange states that the purpose of this provision is to create a record to ensure that hedging trades would be appropriately associated with the related options order and appropriately

<sup>8</sup> The price of an option is not completely dependent on supply and demand, nor on the price of the underlying security. Market-Makers price options based on basic measures of risk as well. One of these such measures, delta, is the rate of change in the price of an option as it relates to changes in the price of the underlying security, security future or futures contract. The delta of an option is measured incrementally based on movement in the price of the underlying security, security future or futures contract. For example, if the price of an option increases or decreases by \$1.00 for each \$1.00 increase or decrease in the price of the underlying security, the option would have a delta of 100. If the price of an option increases or decreases by \$0.50 for each \$1.00 increase or decrease in the price of the underlying security, the option would have a delta of 50.

<sup>9</sup> Volatility is a measure of the fluctuation in the underlying security’s market price. Market-Makers that trade based on volatility have options positions that they hedge with the underlying. Once hedged, the risk exposure to the Market-Maker is realized volatility and implied volatility. Realized volatility is the actual volatility in the underlying. Implied volatility is determined by using option prices currently existing in the market at the time rather than using historical data on the market price changes of the underlying.

<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). See proposed Rule 6.74.10(c)(i) and note 6, *supra*.

<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.

<sup>12</sup> FLEX Options provide investors with the ability to customize basic option features including size, expiration date, exercise style, and certain exercise prices.

<sup>13</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 1,000 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.

<sup>14</sup> In determining whether an individual original order satisfies the eligible order size requirement, any complex order must contain one leg alone which 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 which is for the eligible order size or greater to be eligible for an open outcry crossing entitlement.

<sup>15</sup> As discussed above in note 7, in commenting on the prior Phlx proposal, CBOE suggested that the tied hedge procedures should 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 at 3–4. Particularly given the decreased amount of 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, the Exchange believes that its proposed 500 contract minimum is sufficient to address these considerations. The Exchange intends to evaluate whether 500 contracts is the appropriate threshold and whether smaller sized orders may benefit from the procedures. If any reduction in the eligible size is desired, the Exchange would submit a separate rule filing on this subject in the future.

evaluated in the Exchange's surveillance program. The Exchange believes that this requirement should enable the Exchange to monitor for compliance with the requirements of the proposed rule, as discussed below, by identifying the specific purchase or sell orders relating to the hedging position.

Fourth, the proposed rule would require that members and member organizations that have decided to engage in tied hedge orders for representation in the trading crowd would have to ensure that the hedging position associated with the tied hedge order is comprised 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 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 HOLDR, 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>16</sup> The Exchange states that the purpose of this provision is to ensure that the hedging position would be for the same stock, equivalent security future or related instrument, as applicable, thus allowing crowd participants who may be considering participation in a tied hedge order to adequately evaluate the risk associated with the option as it relates to the hedge. With stock positions in particular, the Exchange notes that occasionally crowd participants hedge option positions with stock that is related to the option, such as the stock of an issuer in the same industry, but not the actual stock associated with the option. Except as otherwise discussed above for index options, the proposed rule change would not allow such a "related" hedging stock position, but would require the hedging stock position to be the actual security underlying the option.

Fifth, the proposal would require that the entire hedging position be brought without undue delay to the trading crowd. In considering whether the hedging position is presented without "undue delay," the Exchange believes that members and member organizations should continue to have the same ability

to shop an order in advance of presenting it to the crowd and should be able to enhance that process through obtaining a hedge. The Exchange also believes that, once a hedge is obtained, the order should be brought to the crowd promptly in order to satisfy the "undue delay" requirement. 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 must also participate in the hedging position on a proportionate basis<sup>17</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 Exchange states that the purpose of these requirements is to ensure that the hedging position represented to the crowd would be a good faith effort to provide in-crowd market participants with the same opportunity as the member or member organization introducing the tied hedge order to compete most effectively for the option order.

For example, if a member or member organization introducing a tied stock hedge order were to offer 1,000 XYZ option contracts to the crowd (overlying 100,000 shares of XYZ stock) and concurrently offer only 30,000 of 100,000 shares of the underlying stock that the member obtained as a hedge, crowd participants might only be willing or able to participate in 300 of the option contracts offered if the hedging stock position cannot be obtained at a price as favorable as the stock hedging position offering price, if at all. The Exchange states that the effect of this would be to place the crowd at a disadvantage relative to the introducing member or member organization for the remaining 700 option contracts in the tied stock hedge order, and thus create a disincentive for the crowd to bid or offer competitively for the remaining 700 option contracts. The Exchange believes the requirement that the hedging position be presented concurrently with the option order in the crowd and offered to the crowd in

its entirety at the execution price received by the member or member organization introducing the order should ensure that the crowd would be competing on a level playing field with the introducing member or member organization to provide the best price to the customer.

Sixth, the proposal would require that the hedging position not exceed the options order on a delta basis. For example, in the situation where a tied stock hedge order involves the simultaneous purchase of 50,000 shares of XYZ stock and the sale of 500 XYZ call contract (known as a "buy-write"), and the delta of the option is 100, it would be considered "hedged" by 50,000 shares of stock. Accordingly, the proposed rule would not allow the introducing member firm to purchase more than 50,000 shares of stock in the hedging stock position. The Exchange believes that it is reasonable to require that the hedging position be in amounts that do not exceed the equivalent size of the related options order on a delta basis, and not for a greater number of shares. The Exchange believes that the proposed rule change would support its view that the member or member organization introducing the tied hedge order be guided by the notion that any excess hedging activity could be detrimental to the eventual execution price of the option order. Consequently, while delta estimates may vary slightly, the introducing member or member organization would be required to assume hedging positions not to exceed the equivalent size of the options order on a delta basis.<sup>18</sup>

<sup>18</sup> 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) 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. To the extent the initiating member is able to execute any portion of the hedge, the risk exposure to the initiating member and in-crowd market participants would be diminished because those shares would be "tied up" and available for everyone that participates on the resulting tied hedge transaction. The Exchange does not believe that the initiating member would have an unfair advantage by having the ability to pre-facilitate less than a delta hedge because the proposed procedures would require the in-crowd market participants to get a proportional share of the hedge. To the extent more stock is needed to complete a hedge, the initiating member and the in-crowd market participants would have the same risk exposure that they do today.

<sup>16</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. See note 13, *supra*.

<sup>17</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).

The Exchange believes that the delta basis requirement, together with the additional conditions that an introducing member or member organization bring the hedging position without undue delay to the trading crowd and announce it concurrently with the option order, offer it to the crowd in its entirety, and offer it at the execution price received by the member or member organization to any in-crowd market participant who has established parity or priority, will help assure that the hedging activity is bona fide and not for speculative or manipulative purposes. Additionally, the Exchange believes these conditions will help assure that there is no adverse effect on the auction market because, as discussed above, in-crowd market participants will have the same opportunity as the member or member organization introducing the tied hedge order to compete for the option order and will share the same benefits of limiting the market risk associated with hedging. The Exchange believes that customers will also benefit if the market risks are limited in the manner proposed. Once an original order is hedged, there is no delta risk. With the delta risk minimized, quotes will likely narrow as market participants (whether upstairs or on-floor) are better able to hedge and compete for orders. For example, Market-Makers could more easily quote markets to trade against a customer's original order based on volatility with the delta risk minimized, which would ultimately present more price improvement opportunities to the original order.<sup>19</sup>

At this time, the Exchange is not proposing any special priority provisions applicable to tied hedge transactions, though it intends to evaluate whether such changes are desired and may submit a separate rule filing on this subject in the future. Under the instant proposal, all tied hedge transactions will be treated as complex orders (regardless of whether the original order was a simple or complex order). Priority will be afforded in accordance with the Exchange's existing open outcry allocation and reporting procedures for complex orders.<sup>20</sup> Any resulting tied hedge

transactions will also be subject to the existing NBBO trade-through requirements for options and stock, as applicable. In this regard, the Exchange believes that the resulting option and stock components of the tied hedge transactions may qualify for various NBBO trade through exceptions including, for example, the complex trade exception to the Options Linkage Program<sup>21</sup> and the qualified contingent trade exception to Rule 611(a) of Regulation NMS for the stock component.<sup>22</sup>

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).

<sup>21</sup> 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 Intermarket Linkage), and subparagraph (b)(7) to CBOE Rule 6.83, *Order Protection*.

<sup>22</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 Exchange recognizes that, at the time a tied hedge transaction is executed in a trading crowd, 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. For example, the execution price may be outside the non-CBOE market's best bid or offer ("BBO"), e.g., the stock leg is to be executed at a price of \$25.03 and the particular stock market's BBO is \$24.93–\$25.02, and such an execution would normally not be permitted unless an exception applies that permits the trade to be reported outside the BBO. The Exchange notes that the possibility of this scenario occurring exists with complex order executions today and tied hedge transactions would present nothing unique or novel in this regard. In the event 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 may ultimately be cancelled in accordance with CBOE's existing rules.<sup>23</sup>

The following examples illustrate these priority principles:

- **Simple Original Order:** Introducing member receives an original customer order to buy 500 XYZ call options, which has a delta of 100. 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 500 contract option order and 50,000 share tied stock hedge at \$25.03 per share to the CBOE trading crowd.

- **Complex Original Order:** Introducing member receives an original 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

the same issuer, or involve the securities of participants in mergers or with intentions to merge 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>23</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. The Exchange intends to address this point in a circular to members should the Exchange receive approval of this proposal.

<sup>19</sup> The Exchange also believes that the proposed exception to the anticipatory hedging procedures will assist in the Exchange's competitive efforts to attract order flow from the OTC market, which may result in increased volume on the exchange markets.

<sup>20</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

member, without undue delay, announces the 500 contract option order and 50,000 share tied stock hedge at \$25.03 per share to the trading crowd.

In either the simple or complex order scenario, the next steps are the same and are no different from the procedures currently used to execute a complex order on CBOE in open outcry.

- The in-crowd market participants would have an opportunity to provide competing quotes for the tied hedge package (and not for the individual component legs of the package). For example, assume the best net price is \$24.53 (equal to \$0.50 for each option contract and \$25.03 for each corresponding share of hedging stock).

- 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 the CBOE and the stock leg being executed and reported on the stock market specified by the initiating member. 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).

- The resultant tied hedge transaction: (i) Would qualify as a "complex trade" under the Options Intermarket Linkage and the execution of the 500 option contracts with the market participants would not be subject to the NBBO for the particular option series; and (ii) would qualify as a "qualified contingent trade" under Regulation NMS and the execution of the 30,000 shares of stock (the original 50,000 shares less the initiating member's 20,000 portion) with the market participants would not be subject to the NBBO for the underlying XYZ stock.

- 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). Thus, if the CBOE BBO for the series was \$0.40–\$0.55, the execution could take place at or inside that price range (e.g., at the quoted price of \$0.50) and could not take place outside that price range (e.g., not at \$0.56).

- Similarly, the execution of the stock at \$25.03 per share would have to satisfy the intra-market priority rules of the non-CBOE market(s) where the stock

is to be executed (including that the execution price may not be outside that market's BBO) or, alternatively, qualify for an exception that permits the trade to be reported outside the non-CBOE market(s)' BBO.

- If market conditions in the non-CBOE market(s) prevent the execution of the stock leg(s) at the price(s) agreed upon from occurring (e.g., the BBO remains at \$24.93–\$25.02), then the options leg(s) could be cancelled at the request of any member that is a party to that trade.<sup>24</sup>

While the particular circumstances surrounding each transaction on the Exchange's trading floor are different, the Exchange does not believe, as a general proposition, that the tied hedge procedures would be inherently harmful or detrimental to customers or have an adverse effect on the auction market. Rather, the Exchange believes the procedures will improve the opportunities for an order to be exposed to a competitive auction and represent an improvement over the current rules. The fact that the parties to such a trade end up fully hedged may contribute to the best execution of the orders,<sup>25</sup> and, in any event, participants continue to be governed by, among other things, their best execution responsibilities. The Exchange also believes that the proposed tied hedge procedures are fully consistent with the original design of Rule 6.9 which, as discussed above, was to eliminate the unfairness that can be associated with a solicited transaction and encourage meaningful competition. The tied hedge procedures will keep in-crowd market participants on equal footing with solicited parties in a manner that minimizes all parties' market risk while continuing to assure that orders are exposed in a meaningful way.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>26</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>27</sup> in particular, because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to

<sup>24</sup> *Id.*

<sup>25</sup> As market participants are better able to hedge risk associated with completing these transactions, the Exchange believes that quotes may narrow and result in increased price improvement opportunities.

<sup>26</sup> 15 U.S.C. 78f(b).

<sup>27</sup> 15 U.S.C. 78f(b)(5).

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, by establishing rules governing tied hedge orders, which include specific requirements and procedures to be followed. Specifically, the Exchange believes the procedures will improve the opportunities for an order to be exposed to price improvement in a manner that will encourage a fair, competitive auction process and minimize all parties' market risk.

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

CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

## C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve the proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File 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 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 March 23, 2009.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority:<sup>28</sup>

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

[FR Doc. E9-4287 Filed 2-27-09; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-59432; File No. SR-FINRA-2009-005]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Update Rule Cross-References and Make Other Various Non-Substantive Technical Changes to FINRA Rules

February 23, 2009.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

(“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 13, 2009, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by FINRA. FINRA has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,<sup>3</sup> which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to update rule cross-references and make other non-substantive technical changes to certain FINRA rules that have been adopted in the consolidated FINRA rulebook.

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

FINRA is in the process of developing a new consolidated rulebook (“Consolidated FINRA Rulebook”).<sup>4</sup>

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

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

<sup>3</sup> 17 CFR 240.19b-4(f)(6).

<sup>4</sup> The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE

That process involves FINRA submitting to the Commission for approval a series of proposed rule changes over time to adopt rules in the Consolidated FINRA Rulebook. The phased adoption and implementation of those rules necessitates periodic amendments to update rule cross-references and other non-substantive technical changes in the Consolidated FINRA Rulebook.

The proposed rule change would update rule cross-references in FINRA Rules 2360, 2370, 6181, 6635, 9217 and 9610 that are needed as the result of Commission approval of three recent FINRA proposed rule changes.<sup>5</sup> In addition, the proposed rule change would amend FINRA Rule 7410(m) to update cross-references to NYSE Rule 80A, which was renumbered as NYSE Rule 132B.<sup>6</sup> Finally, the proposed rule change would amend FINRA Rule 5130 to reflect a change in FINRA style convention when referencing SEC rules and regulations.

FINRA has filed the proposed rule change for immediate effectiveness and has requested that the SEC waive the requirement that the proposed rule change not become operative for 30 days after the date of the filing, such that FINRA could implement the proposed rule change on February 17, 2009, the date on which certain of the previously approved rule changes will also be implemented.<sup>7</sup>

###### 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>8</sup> which requires, among other things, that FINRA rules must be designed to

Rules apply only to those members of FINRA that are also members of the NYSE (“Dual Members”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see FINRA Information Notice, March 12, 2008 (Rulebook Consolidation Process).

<sup>5</sup> See Securities Exchange Act Release No. 58643 (September 25, 2008), 73 FR 57174 (October 1, 2008) (Order Approving File Nos. SR-FINRA-2008-021; SR-FINRA-2008-022; SR-FINRA-2008-026; SR-FINRA-2008-028 and SR-FINRA-2008-029); Securities Exchange Act Release No. 58661 (September 26, 2008), 73 FR 57395 (October 2, 2008) (Order Approving File No. SR-FINRA-2008-030); Securities Exchange Act Release No. 58932 (November 12, 2008), 73 FR 69696 (November 19, 2008) (Order Approving File No. SR-FINRA-2008-032).

<sup>6</sup> See Securities Exchange Act Release No. 56726 (October 31, 2007), 72 FR 62719 (November 6, 2007) (Notice of Filing and Immediate Effectiveness of File No. SR-NYSE-2007-96).

<sup>7</sup> See FINRA Regulatory Notice 08-78 (December 2008) (FINRA Announces SEC Approval and Effective Date for New Consolidated FINRA Rules Relating to Warrants, Options and Security Futures).

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

<sup>28</sup> 17 CFR 200.30-3(a)(12).