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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

Item 1. Text of Proposed Rule Change

(a) The Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) proposes to amend Rules 6.45A, Priority and Allocation of Equity Option Trades on the CBOE Hybrid System, and 6.45B, Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System, to revise its market turner and modified participation entitlement priority overlays. The text of the proposed rule change is provided below (additions are underlined; deletions are [bracketed]).

* * * * *

Chicago Board Options Exchange, Incorporated
Rules

* * * * *

Rule 6.45A - Priority and Allocation of
Equity Option Trades on the CBOE Hybrid System

* * * * *

(a) Allocation of Incoming Electronic Orders: The Exchange will determine to apply, for each class of options, one of the following rules of trading priority described in paragraphs (i) or (ii). The Exchange will issue a Regulatory Circular periodically specifying which priority rules will govern which classes of options any time the Exchange changes the priority.

* * * * *

(ii) Price-Time or Pro-Rata Priority

* * * * *

Additional Priority Overlays Applicable to Price-Time or Pro-Rata Priority Methods

In addition to the base allocation methodologies set forth above, the Exchange may determine to apply, on a class-by-class basis, one or more of the following designated market participant overlay priorities in a sequence determined by the Exchange. The Exchange will issue a Regulatory Circular periodically which will specify which classes of options are subject to these additional priorities as well as any time the Exchange changes these priorities.

* * * * *

(3) Modified Participation Entitlement: This participation entitlement is the same as provided in subparagraph (2) above or subparagraph (iii)(1) below, except [as follows: Notwithstanding subparagraph (2)(D) above,] the participation entitlement shall only be applied to the execution of an inbound order if [there are no Public Customer orders resting at the best price or if a Public Customer was the first

to rest interest at the best price] the amount the Market-Maker would be entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the operation of the Algorithm described above. In all other cases, the participation entitlement and public customer priority will not be applied.

(A) The Market-Maker entitlement shall be calculated based on any remaining balance after all public customer orders at the best price are satisfied. For options classes where the Algorithm uses the pro-rata method, the Exchange may determine on a class-by-class basis to calculate the Market-Maker's entitlement share using the UMA method provided in subparagraph (a)(i)(C) above or the pro-rata method provided in subparagraph (b)(ii)(2) above.

(B) When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the Algorithm, the participation entitlement and public customer priority will not be [in effect] considered.

The[is] modified participation entitlement overlay is only applicable to automatic executions and will not be applicable for executions of incoming electronic orders initiated from PAR or for electronic auctions. In classes where the UMA method is selected to calculate the Market-Maker entitlement, executions of incoming electronic orders initiated from PAR and electronic auctions will be allocated using the UMA method.

[(4) Market Turner: "Market Turner" means a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order (quote) is continuously in the market until the particular order (quote) trades. There may be a Market Turner for each price at which a particular order trades. When this priority overlay is in effect, the Market Turner has priority at the highest bid or lowest offer that he established. The Market Turner priority at a given price remains with the order (quote) once it is earned. For example, if the market moves in the same direction as the direction in which the order from the Market Turner moved the market, and then the market moves back to the Market Turner's original price, then the Market Turner retains priority at the original price. Market Turner priority cannot be established until after the opening print and/or the conclusion of the opening rotation and, once established, shall remain in effect until the conclusion of the trading session.

The Exchange may determine, on a class-by-class basis, to reduce the Market Turner priority to a percentage of each inbound order that is executable against the Market Turner. In such cases, the Market Turner may participate in the balance of an order, pursuant to the allocation procedure in effect, after the Market Turner priority has been applied. To the extent the Market Turner order (quote) is not fully exhausted, it shall retain Market Turner priority for subsequent inbound orders until the conclusion of the trading session.]

(iii) Additional Priority Overlays Applicable to [Small Orders] All Priority Methods
In addition to the base allocation methodologies set forth above, the Exchange may determine to apply, on a class-by-class basis, the following priority overlays. The Exchange

will issue a Regulatory Circular periodically specifying which classes of options are subject to these additional priorities any time the Exchange changes these priorities.

(1) Small Order Preference:

(A) – (D) No change.

(2) Market Turner: “Market Turner” means a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order (quote) is continuously in the market until the particular order (quote) trades. There may be a Market Turner for each price at which a particular order trades. When this priority overlay is in effect, the Market Turner has priority at the highest bid or lowest offer that he established. The Market Turner priority at a given price remains with the order (quote) once it is earned. For example, if the market moves in the same direction as the direction in which the order from the Market Turner moved the market, and then the market moves back to the Market Turner’s original price, then the Market Turner retains priority at the original price. Market Turner priority cannot be established until after the opening print and/or the conclusion of the opening rotation and, once established, shall remain in effect until the conclusion of the trading session.

The Exchange may determine, on a class-by-class basis, to reduce the Market Turner priority to a percentage of each inbound order that is executable against the Market Turner. In such cases, the Market Turner may participate in the balance of an order, pursuant to the allocation procedure in effect, after the Market Turner priority has been applied. To the extent the Market Turner order (quote) is not fully exhausted, it shall retain Market Turner priority for subsequent inbound orders until the conclusion of the trading session.

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Rule 6.45B - Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System

* * * * *

(a) Allocation of Incoming Electronic Orders: The Exchange will determine to apply, for each class of options, one of the following rules of trading priority described in paragraphs (i) or (ii). The Exchange will issue a Regulatory Circular periodically specifying which priority rules will govern which classes of options any time the Exchange changes the priority.

(i) Price-Time or Pro-Rata Priority

* * * * *

Additional Priority Overlays Applicable to Price-Time or Pro-Rata Priority Methods

* * * * *

(3) Modified Participation Entitlement: This participation entitlement is the same as provided in subparagraph (2) above or subparagraph (iv)(1) below, except [as follows: Notwithstanding subparagraph (2)(D) above,] the participation entitlement shall only be applied to the execution of an inbound order if [there are no Public Customer orders resting at the best price or if a Public Customer was the first to rest interest at the best price] the amount the Market-Maker would be entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would

otherwise receive pursuant to the operation of the Algorithm described above. In all other cases, the participation entitlement and public customer priority will not be applied.

(A) The Market-Maker entitlement shall be calculated based on any remaining balance after all public customer orders at the best price are satisfied. For options classes where the Algorithm uses the pro-rata method, the Exchange may determine on a class-by-class basis to calculate the Market-Maker's entitlement share using the pro-rata method provided in subparagraph (a)(i)(2) above or the UMA method provided in subparagraph (a)(ii)(C) below.

(B) When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the Algorithm, the participation entitlement and public customer priority will not be [in effect] considered. The[is] modified participation entitlement overlay is only applicable to automatic executions and will not be applicable for executions of incoming electronic orders initiated from PAR or for electronic auctions. In classes where the UMA method is selected to calculate the Market-Maker entitlement, executions of incoming electronic orders initiated from PAR and electronic auctions will be allocated using the UMA method.

[(4) Market Turner: "Market Turner" means a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order (quote) is continuously in the market until the particular order (quote) trades. There may be a Market Turner for each price at which a particular order trades. When this priority overlay is in effect, the Market Turner has priority at the highest bid or lowest offer that he established. The Market Turner priority at a given price remains with the order (quote) once it is earned. For example, if the market moves in the same direction as the direction in which the order from the Market Turner moved the market, and then the market moves back to the Market Turner's original price, then the Market Turner retains priority at the original price. Market Turner priority cannot be established until after the opening print and/or the conclusion of the opening rotation and, once established, shall remain in effect until the conclusion of the trading session.

The Exchange may determine, on a class-by-class basis, to reduce the Market Turner priority to a percentage of each inbound order that is executable against the Market Turner. In such cases, the Market Turner may participate in the balance of an order, pursuant to the allocation procedure in effect, after the Market Turner priority has been applied. To the extent the Market Turner order (quote) is not fully exhausted, it shall retain Market Turner priority for subsequent inbound orders until the conclusion of the trading session.]

* * * * *

(iii) Additional Priority Overlays Applicable to [Small Orders] All Priority Methods

In addition to the base allocation methodologies set forth above, the Exchange may determine to apply, on a class-by-class basis, the following priority overlays. The Exchange will issue a Regulatory Circular periodically specifying which classes of options are subject to th[is]ese additional priorit[y]ies any time the Exchange changes these priorit[y]ies.

(1) Small Order Preference:

(A) – (D) No change.

(2) Market Turner: “Market Turner” means a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order (quote) is continuously in the market until the particular order (quote) trades. There may be a Market Turner for each price at which a particular order trades. When this priority overlay is in effect, the Market Turner has priority at the highest bid or lowest offer that he established. The Market Turner priority at a given price remains with the order (quote) once it is earned. For example, if the market moves in the same direction as the direction in which the order from the Market Turner moved the market, and then the market moves back to the Market Turner’s original price, then the Market Turner retains priority at the original price. Market Turner priority cannot be established until after the opening print and/or the conclusion of the opening rotation and, once established, shall remain in effect until the conclusion of the trading session.

The Exchange may determine, on a class-by-class basis, to reduce the Market Turner priority to a percentage of each inbound order that is executable against the Market Turner. In such cases, the Market Turner may participate in the balance of an order, pursuant to the allocation procedure in effect, after the Market Turner priority has been applied. To the extent the Market Turner order (quote) is not fully exhausted, it shall retain Market Turner priority for subsequent inbound orders until the conclusion of the trading session.

* * * * *

(b) Not applicable.

(c) Not applicable.

Item 2. Procedures of the Self-Regulatory Organization

(1) The proposed rule change was approved by the Exchange’s Office of the Chairman pursuant to delegated authority on October 20, 2009. No further action is required.

(2) Questions and comments on the proposed rule change may be referred to Joanne Moffic-Silver, General Counsel, CBOE, 400 South LaSalle Street, Chicago, Illinois 60605; Telephone: (312) 786-7462; Fax: (312) 786-7919 or Jennifer Lamie at 312-786-7576.

Item 3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

Amendment 1 replaces the original filing in its entirety. The purpose of this amendment is to expand the discussion to clarify the intent of the original proposal and to make typographical corrections.

Background

CBOE Rules 6.45A and 6.45B set forth, among other things, the manner in which incoming electronic orders in options are allocated on the Hybrid System. Paragraph (a) of each rule currently provides a “menu” of allocation algorithms to choose from when executing incoming electronic orders. The menu format allows the Exchange to utilize different allocation algorithms on a class-by-class basis. The menu includes, among other choices, the Ultimate Matching Algorithm (“UMA”),¹ and price-time and pro-rata priority allocation algorithms. Additional priority overlays can be applied to the base allocation algorithms. The price-time and pro-rata priority overlays currently include: public customer priority for public customer orders resting on the Hybrid System, participation entitlements for certain qualifying market-makers² (the “original participation entitlement(s)”) ³ and a

¹ Under the UMA algorithm, public customer orders in the electronic book have first priority to trade against incoming electronic orders, then the Market-Maker participation entitlement has second priority. Thereafter, any remaining balance of the incoming order, if any, is allocated among other market participants based on a weighting of the number of market participants quoting at the best bid or offer (Component A) and the percentage that the size of each market participant's quote is at the best bid or offer relative to the total number of contracts at the disseminated quote (Component B). See Rules 6.45A(a)(i)(B)(2) and 6.45B(a)(ii)(B)(2) for a more detailed description of UMA.

² Under the original participation entitlement, the Exchange may determine to grant Market-Makers participation entitlements pursuant to the provisions of Rules 8.87,

market turner priority for participants that are first to improve CBOE's disseminated quote.

In addition, a small order participation entitlement overlay for Designated Primary Market-

Participation Entitlement of DPMs and e-DPMs, 8.13, Preferred Market-Maker Program, or 8.15B, Participation Entitlement of LLMs. More than one such participation entitlements may be activated for an option class (including at different priority sequences), however in no case may more than one participation entitlement be applied on the same trade. In allocating the participation entitlement, all of the following apply: (i) To be entitled to their participation entitlement, the Market-Maker's order and/or quote must be at the best price on the Exchange. (ii) The Market-Maker may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price. If pro-rata priority is in effect, and Market-Maker's allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted, the Market-Maker shall not receive any further allocation of that order. (iii) In establishing the counterparties to a particular trade, the participation entitlement must first be counted against that Market-Maker's highest priority bids or offers. (iv) The participation entitlement shall not be in effect unless the public customer priority is in effect in a priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance. See Rules 6.45A(a)(ii)(2) and 6.45B(a)(i)(2).

- 3 The terms of the original participation entitlement(s) vary depending on the particular base allocation algorithm. For UMA classes, the Market-Maker receives an allocation that is either (i) the greater of the amount the Market-Maker would be entitled to pursuant to the participation entitlement or the amount it would otherwise receive pursuant to the operation of the UMA algorithm, (ii) the amount the Market-Maker would be entitled to pursuant to the participation entitlement or (iii) in index and ETF option classes, the amount the Market-Maker would be entitled to receive pursuant to the operation of the UMA algorithm. The Exchange determines which of the various entitlement formulas will be in effect on a class-by-class basis. Also, under formulas (i) and (ii) above, additional "Component A" allocations are provided to certain On-Floor DPMs and On-Floor LMMs. See Rules 6.45A(a)(i)(C) and 6.45B(a)(ii)(C). For pro-rata classes, the Market-Maker would receive a participation that is the greater of its participation entitlement or its pro-rata allocation share. For price-time classes, the Market-Maker would receive a participation entitlement and a time priority share on any remaining balance. Whether UMA, pro-rata, or price-time priority is in effect for an options class, each allocation calculation is based on any remaining balance of the incoming order after public customer priority is applied, as well as after any other higher ranked priority overlay, such as market turner priority, is applied.

Makers (“DPMs”) and Lead Market-Makers (“LMMs”) can be applied to each of the three allocation algorithms (i.e., price-time, pro-rata or UMA).⁴ These overlays are all optional.

The Exchange recently adopted another priority overlay for the price-time and pro-rata allocation algorithms that the Exchange refers to as the “modified participation entitlement.”⁵ The modified participation entitlement currently operates in the same manner as the original participation entitlement(s) with a few exceptions. In particular, the modified participation entitlement provides that, if at the time of execution of an inbound order there are no Public Customer orders resting at the best price or a Public Customer was the first to rest interest at the best price, then the original participation entitlement(s) will be applied. In all other cases, participation entitlement and public customer priority overlays will not be in effect. This modified participation entitlement overlay is only applicable to automatic executions and is not applicable for auctions. Lastly, like the other priority overlays, the modified participation entitlement is optional. The Exchange can determine whether one or more of the priority overlays shall apply to an option class and if more than one is selected, the sequence in which they shall apply (consistent with applicable rules). All determinations are set forth in a regulatory circular.

⁴ If the small order priority overlay is in effect for an option class, then orders for five (5) contracts or fewer will be executed first by the DPM or LMM, as applicable, appointed to the option class. This participation entitlement is subject to certain conditions, including a condition that public customer priority must be in effect in priority sequence ahead of the participation entitlement. See Rules 6.45A(a)(iii) and 6.45B(a)(iii).

⁵ Securities Exchange Act Release No. 60665 (September 14, 2009), 74 FR 4814 (September 21, 2009)(SR-CBOE-2009-052).

Amendments to Market Turner and Modified Participation Entitlement Priority Overlays

The purpose of this rule change is to revise the market turner and modified participation entitlement priority overlays in various respects described below. First, currently the rules provide that the market turner priority overlay is only available for classes utilizing the price-time and pro-rata algorithms. The Exchange is now proposing to amend the rules to make this entitlement overlay available for classes utilizing any of the priority methods utilized by the Exchange.

Second, currently the modified participation entitlement overlay available for the price-time and pro-rata priority methods is only applicable to automatic executions of incoming electronic orders. It is not applicable to electronic auctions. The Exchange is also proposing to provide that the modified participation entitlement overlay would not be applicable for executions of incoming electronic orders initiated from PAR.⁶ Instead, as described in more detail below, the original participation entitlement parameters would be applied when PAR is used to initiate an execution of an electronic order.⁷ Thus, this outcome would be no change from how the original participation entitlement(s) works today when PAR is utilized.

Third, currently the modified participation entitlement overlay available for the price-time and pro-rata priority methods only modifies the application of the original participation entitlement. It does not modify the application of the small order participation entitlement

⁶ PAR is utilized to accommodate trading in open outcry, where different rules on electronic book priority apply. For example, in open outcry at the same price, public customer orders in the electronic book have first priority, bid (offers) of in-crowd market participants have second priority, and bids (offers) of broker-dealer orders in the electronic book and electronic quotes of Market-Makers have third priority. See, e.g., Rules 6.45A(b) and 6.45B(b).

⁷ See note 8, infra.

for DPMs and LMMs. The Exchange is proposing to provide that the modified participation entitlement overlay would also be available to modify the application of the small order participation entitlement.

Fourth, currently under the modified participation entitlement overlay available for options classes utilizing the price-time or pro-rata method, a participation entitlement(s) is only applied if there are no Public Customer orders resting at the best price or if a Public Customer was the first to rest interest at the best price. In all other cases, the participation entitlement and public customer priority overlays are not in effect for the allocation of incoming electronic orders.

The Exchange is proposing to replace this provision with what we refer to as the “greater than” provision. Under this provision, a Market-Maker that is the subject of a participation entitlement (including a small order participation entitlement) would only receive an entitlement if the amount the Market-Maker would be entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm. In all other cases, the participation entitlement and public customer priority would not be applied. This allocation would be subject to the following:

- The Market-Maker’s entitlement share would be calculated based on any remaining balance after all public customer orders at the best price are satisfied. For options classes using the pro-rata method, the Exchange may determine on a class-by-class basis to calculate the Market-Maker’s entitlement share using the UMA methodology or the pro-rata methodology. For options classes using the

price-time method, the Market-Maker's entitlement share would be calculated using the price-time methodology only.⁸

- When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, the participation entitlement and public customer priority overlays would not be considered. Instead the calculation would be based on a price-time or pro-rata basis, as applicable, and subject to any other applicable priority overlays, such as market turner priority.

The following example illustrates some outcomes when using CBOE's existing allocation algorithms and when using the proposed modified participation entitlement. Assume that an incoming electronic order for 24 contracts is received and that the following trading interest is represented at the execution price: three Market-Makers for 10 contracts each, the DPM for 40 contracts, and a public customer for 10 contracts.

- In a class where the algorithm is simply pro-rata, each Market-Maker is allocated 3 contracts, the DPM is allocated 12 contracts, and the public customer is allocated 3 contracts.
- In a class where the algorithm is pro-rata with original DPM entitlement and public customer priority overlays, the public customer is allocated 10 contracts,

⁸ This modified participation entitlement overlay would only be applicable to automatic executions and would not be applicable for executions of incoming electronic orders initiated from PAR or from electronic auctions. Instead, the original participation entitlement parameters would be applied for PAR and electronic auctions. In pro-rata classes where the UMA method is selected to calculate the Market-Maker's modified participation entitlement share, executions of incoming electronic orders initiated from PAR and electronic auctions would be allocated using the UMA method. Therefore, in such classes, the Market-Maker's original participation entitlement share of a PAR or electronic auction execution would be calculated using the UMA method.

the DPM is allocated 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70), and each Market-Maker is allocated 2 contracts.

- In a class where the algorithm is pro-rata with the proposed modified DPM entitlement overlay (and the DPM entitlement is calculated based on the pro-rata method), the allocation would be simple pro-rata because the DPM's pro-rata share of 12 contracts (24 contracts * pro-rata share of 40/80) is greater than the DPM's entitlement share of 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70). Therefore, each Market-Maker would be allocated 3 contracts, the DPM would be allocated 12 contracts, and the public customer would be allocated 3 contracts.
- In a class where the algorithm is pro-rata with the proposed modified DPM entitlement overlay (and the DPM entitlement is calculated based on UMA using a 0% Component A weighting and a 100% Component B weighting),⁹ the allocation would be simple pro-rata because the DPM's pro-rata share of 12 contracts (24 contracts * pro-rata share of 40/80) is greater than the DPM's UMA entitlement share of 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70). Therefore, each Market-Maker would be allocated 3 contracts, the DPM would be allocated 12 contracts, and the public customer would be allocated 3 contracts.¹⁰

⁹ For purposes of this example, assume that the original DPM participation entitlement is based on the greater of the amount the DPM would be entitled to pursuant to the participation entitlement or the amount it would otherwise receive pursuant to the operation of the UMA algorithm. See note 3, supra.

¹⁰ As another example, assume that an incoming electronic order for 4 contracts is received and that the following trading interest is represented at the execution price:

As illustrated above, the outcomes that would result when the modified participation entitlement is activated in a class are not novel or unique. Each outcome is an allocation that is currently permitted under CBOE's existing allocation rules. Specifically:

- for classes using a price-time methodology, the resulting allocation would be either a simple price-time allocation or a price-time allocation with a participation entitlement after yielding to all public customer orders at the best price; and
- for classes using a pro-rata methodology, the resulting allocation would be either a simple pro-rata allocation, a pro-rata allocation with a participation entitlement after yielding to all public customer orders at the best price or, if applicable, an UMA allocation with a participation entitlement after yielding to all public customer orders at the best price.

Put another way, the allocation that occurs when a modified participation entitlement is applied would be no change from how the allocation operates under the existing rules for a class utilizing the original participation entitlement (and small order participation entitlement). Specifically, if the amount the Market-Maker would be entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, then the participation entitlement allocation share will continue to be calculated based on any remaining balance of the incoming order after public customer priority and any other priority overlay ranked ahead of the entitlement. When calculating the amount the Market-Maker would otherwise receive

three Market-Makers for 10 contracts each, the DPM for 40 contracts, and a public customer for 10 contracts. In a class where the algorithm is pro-rata with the proposed modified participation entitlement for small orders, the allocation would be simple pro-rata because the DPM's pro-rata share 2 contracts (4 contracts * pro-rata share of 40/80) is greater than the DPM's small order preference entitlement share of 0 contracts (0 contracts remaining after the public customer order * 100%).

pursuant to the operation of the algorithm, the resulting allocation would be no change from how the allocation would operate under the existing rules for a class utilizing a simple price-time or pro-rata algorithm. Specifically, the Hybrid System will calculate the Market-Maker's price-time or pro-rata share, as applicable, without regard to any public customer priority or participation entitlement priority (because public customer priority would not be applied when a participation entitlement is not applied). Any other higher ranked priority overlays, such as market turner priority, will be considered in determining the balance of the incoming order to be allocated under the price-time or pro-rata algorithms, as applicable.

The notion of a "greater than" concept for determining the participation entitlement amount is also not novel or unique.¹¹ The primary distinction with the instant proposal is that, under the original participation entitlement, public customer priority must be applied in a priority sequence ahead of the participation entitlement at all times for the entitlement to be in effect. Under the modified participation entitlement, public customer priority will not be "hardcoded" into the algorithm methodology – instead the participation entitlement and public customer priority will only be applied if the entitlement share is greater than the price-time or pro-rata share, as applicable, and subject to any other applicable priority overlays, such as market turner priority. This distinction itself is not entirely novel or unique. In this regard, the Exchange notes, for example, that the price-time algorithm being proposed is

¹¹ For example, a CBOE Market-Maker gets the greater of its UMA share (price-time or pro-rata share, if applicable) or entitlement share. See CBOE Rules 6.45A(a)(i) and (ii) and 6.45B(a)(i) and (ii). On NYSE Arca, Inc. ("Arca"), an LMM or directed option market maker ("DOMM") gets the greater of its price-time share or, subject to public customer priority, entitlement share. See Arca Rule 6.76A(a). On the International Securities Exchange, LLC ("ISE"), an primary market maker or preferred market maker gets the greater of its pro-rata share or entitlement share, which is applied after priority customers but based on the total order size (as opposed to size remaining after priority customers are satisfied). See ISE Rule 713.01 and .03.

substantially similar to what currently exists on at least one other options exchange, except that CBOE would propose to yield to all public customer orders at the same price when a Market-Maker participation entitlement is applied (not just public customer orders received in time sequence ahead of the Market-Maker receiving the entitlement).¹²

The Exchange notes that the Securities and Exchange Commission (“Commission”) has stated that priority of public customer orders is not an essential attribute of an exchange and in the past the Commission has approved trading rules at options exchanges that do not give priority to public customers that are priced no better than the orders of other market participants.¹³ Indeed, the Exchange’s price-time and pro-rata methodologies discussed above are examples of allocation methodologies that do not require public customer priority. However, when an entitlement applies (such as the Market-Maker participation entitlement or a crossing entitlement), the Commission has had a general policy for the options exchanges to require yielding to all public customers at the same price before the entitlement can be applied.¹⁴ CBOE’s proposed amendments to the modified participation entitlement are entirely consistent with this policy objective – before any entitlement can be applied, all public customer orders at the best price must be satisfied. There is no requirement that public customer priority be “hardcoded” on every allocation, only those allocations where an entitlement is applied.¹⁵

¹² See, e.g., Arca Rule 6.76A(a).

¹³ See Securities Exchange Act Release No. 61198 (December 17, 2009), 74 FR 68880 (December 29, 2009)(SR-CBOE-2009-078).

¹⁴ See, e.g., CBOE Rules 6.45A, 6.45B, 6.74, 6.74A and 6.74B, and ISE Rules 713, 716 and 723. Arca Rule 6.76A(a) is a slight exception because it only requires yielding to public customers at the same price that have time priority over the LMM or DOMM.

¹⁵ Arca’s price-time and LMM/DOMM entitlement is one example. See, e.g., Arca

The Exchange believes that public customers will be treated equitably and fairly under the proposed rule change. We are proposing to apply a general allocation algorithm where all market participants are treated equally (i.e., price-time or pro-rata, as applicable, and subject to any other applicable priority overlays, such as market turner priority) and, to the extent a Market-Maker participation entitlement is applied, to apply the entitlement only after all public customer orders at the same price have been satisfied. The proposed amendments to the modified participation entitlement do not serve to in any way disadvantage public customers or advantage other market participants over public customers. In fact, the proposed amendments actually favor public customers because they receive an added benefit if any entitlement is applied (i.e., they are completely satisfied with a 100% fill) when public customers would otherwise only receive a price-time or pro-rata share like any other market participant. Moreover, the Exchange believes that the modified participation entitlement, as amended, would encourage quote competition because is designed to reward aggressive pricing by offering incentives both for Market-Makers to support and participate in the CBOE marketplace and for market participants to establish the best price or quote at the best price with size. In classes utilizing a price-time algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by establishing the best price. In classes utilizing a pro-rata algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by quoting more size.

Rule 6.76A(a). CBOE's price-time or pro-rata and existing modified participation entitlement are other examples. See CBOE Rules 6.45A(a)(ii)(3) and 6.45B(a)(i)(3).

With each incoming electronic order, public customers can expect to receive their respective price-time or pro-rata share (same as other market participants) or, in some cases, a 100% fill.¹⁶ To the extent that public customers may strategically rest orders based on the allocation algorithm employed at a given exchange,¹⁷ public customers can adjust their “quoting” behavior accordingly, similar to how they and other market participants already would do today. Several market characteristics factor into a market participant’s quoting behavior including, but certainly not limited to, the applicable fee structure, average incoming order size, and the average touch rate (i.e., average allocation a market participant actually receives on incoming electronic orders). The allocation for any market participant (including public customers) changes constantly from order-to-order, second-to-second for various reasons. For instance on CBOE the ultimate allocation depends upon, among other things, the size of an incoming order and whatever trading interest happens to be represented at the time the order is received (e.g., one second only public customers may be represented at the best price, in which case the allocation to an individual customer is based on time priority; the next second there may be one public customer and multiple market makers at the best price, in which case the allocation to the customer is based on customer priority regardless of when the customer entered the order and to the other market-makers based on a

¹⁶ That the Exchange may use a pro-rata or UMA methodology to determine the Market-Maker’s entitlement percentage does not have any impact from the public customer’s perspective. The public customer either gets a pro-rata share or a 100% fill. See, e.g., notes 9 and 10, supra, and surrounding discussion.

¹⁷ The Exchange believes that public customers that are traditional retail investors do not typically enter resting orders based on allocation algorithms, so this change will not impact them. To the contrary, public customers actually benefit from the proposed allocation methodology because they get a minimum price-time or pro-rata share and, sometimes, a 100% fill before other market participants. Voluntary Professional and Professional customers are treated the same as broker-dealers (not public customers) under CBOE’s allocation rules. See Rule 1.1(ff) and (ggg).

price-time (or pro-rata or UMA share, if applicable) and any applicable entitlement share; a few seconds later there may be a market-turner, in which case the market turner trades first either entirely or based on a percentage share, then public customers at the best price trade based on time priority; the next second there may be only one public customer at the best price and incoming order takes out the entire balance of the resting order).

In determining their desired quote size and price, other market participants already account for the existence or non-existence of a Market-Maker entitlement (the entitlement may or may not be applied on an order-by-order basis and to different degrees under the current rules depending on, for example, whether a Market-Maker with an entitlement is actually quoting at the best price, the size of the Market-Maker's quote, the number of other Market-Makers quoting at that price, and the size of the incoming order). Under the proposed rule change, public customers that may adjust their quoting dynamics based upon, among other things, the applicable allocation algorithm may also want to account for the existence or non-existence of a Market-Maker entitlement, similar to how other market participants would already do today.¹⁸

(2) Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the "Act")¹⁹ and the rules thereunder, and in particular with: Section 6(b)(5) of the Act, which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles

¹⁸ For example, the impact of the proposed rule change would be reflected in a customer's average touch rate, which the customer might then use to determine size and price when entering orders.

¹⁹ 15 U.S.C. 78f(b).

of trade, to remove impediments to and perfect the mechanism for 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;²⁰ and Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or in furtherance of the Act.²¹ The proposed rule change ensures that incoming electronic orders are allocated in an equitable and fair manner and that all market participants (including public customers) have a fair and reasonable opportunity for allocations based on established criteria and procedures. CBOE believes that the change will allow the Exchange other methods to reward aggressive pricing in options trading on the Hybrid System by making market maker available for classes utilizing any of the priority methods utilized by the Exchange. CBOE also believes that the modified participation entitlement, as amended, would encourage quote competition because it is designed to reward aggressive pricing by offering incentives both for Market-Makers to support and participate in the CBOE marketplace and for market participants to establish the best price or quote at the best price with size. In classes utilizing a price-time algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by establishing the best price. In classes utilizing a pro-rata algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by quoting more size.

Item 4. Self-Regulatory Organization's Statement on Burden on Competition

This proposed rule change does not impose any burden on competition that is not

²⁰ 15 U.S.C. 78f(b)(5).

²¹ 15 U.S.C. 78f(b)(8).

necessary or appropriate in furtherance of the purposes of the Act.

Item 5. 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.

Item 6. Extension of Time Period for Commission Action

The Exchange does not consent to an extension of the time period specified in Section 19(b)(2) of the Act²² for Commission consideration of the proposed rule change.

Item 7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

Item 8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or the Commission

Not applicable.

Item 9. Exhibits

Exhibit 1. Form of Notice of Proposed Rule Change for publication in the Federal Register.

²² 15 U.S.C. 78s(b)(2).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-CBOE-2010-038)

Dated: _____

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change Related to the Hybrid Matching Algorithms

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on _____, 2010, the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “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 amend Rules 6.45A, Priority and Allocation of Equity Option Trades on the CBOE Hybrid System, and 6.45B, Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System, to revise its market turner and modified participation entitlement priority overlays. The text of the proposed rule change is available on the Exchange’s website (<http://www.cboe.org/Legal>), at the Office of the Secretary, CBOE and at the Commission.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

In its filing with the Commission, the self-regulatory organization 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 those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

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

1. Purpose

Amendment 1 replaces the original filing in its entirety. The purpose of this amendment is to expand the discussion to clarify the intent of the original proposal and to make typographical corrections.

Background

CBOE Rules 6.45A and 6.45B set forth, among other things, the manner in which incoming electronic orders in options are allocated on the Hybrid System. Paragraph (a) of each rule currently provides a “menu” of allocation algorithms to choose from when executing incoming electronic orders. The menu format allows the Exchange to utilize different allocation algorithms on a class-by-class basis. The menu includes, among other choices, the Ultimate Matching Algorithm (“UMA”),³ and price-time and pro-rata priority

³ Under the UMA algorithm, public customer orders in the electronic book have first priority to trade against incoming electronic orders, then the Market-Maker participation entitlement has second priority. Thereafter, any remaining balance of the incoming order, if any, is allocated among other market participants based on a weighting of the number of market participants quoting at the best bid or offer (Component A) and the percentage that the size of each market participant’s quote is at the best bid or offer relative to the total number of contracts at the disseminated

allocation algorithms. Additional priority overlays can be applied to the base allocation algorithms. The price-time and pro-rata priority overlays currently include: public customer priority for public customer orders resting on the Hybrid System, participation entitlements for certain qualifying market-makers⁴ (the “original participation entitlement(s)”) ⁵ and a

quote (Component B). See Rules 6.45A(a)(i)(B)(2) and 6.45B(a)(ii)(B)(2) for a more detailed description of UMA.

⁴ Under the original participation entitlement, the Exchange may determine to grant Market-Makers participation entitlements pursuant to the provisions of Rules 8.87, Participation Entitlement of DPMs and e-DPMs, 8.13, Preferred Market-Maker Program, or 8.15B, Participation Entitlement of LLMs. More than one such participation entitlements may be activated for an option class (including at different priority sequences), however in no case may more than one participation entitlement be applied on the same trade. In allocating the participation entitlement, all of the following apply: (i) To be entitled to their participation entitlement, the Market-Maker’s order and/or quote must be at the best price on the Exchange. (ii) The Market-Maker may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price. If pro-rata priority is in effect, and Market-Maker’s allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted, the Market-Maker shall not receive any further allocation of that order. (iii) In establishing the counterparties to a particular trade, the participation entitlement must first be counted against that Market-Maker’s highest priority bids or offers. (iv) The participation entitlement shall not be in effect unless the public customer priority is in effect in a priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance. See Rules 6.45A(a)(ii)(2) and 6.45B(a)(i)(2).

⁵ The terms of the original participation entitlement(s) vary depending on the particular base allocation algorithm. For UMA classes, the Market-Maker receives an allocation that is either (i) the greater of the amount the Market-Maker would be entitled to pursuant to the participation entitlement or the amount it would otherwise receive pursuant to the operation of the UMA algorithm, (ii) the amount the Market-Maker would be entitled to pursuant to the participation entitlement or (iii) in index and ETF option classes, the amount the Market-Maker would be entitled to receive pursuant to the operation of the UMA algorithm. The Exchange determines which of the various entitlement formulas will be in effect on a class-by-class basis. Also, under formulas (i) and (ii) above, additional “Component A” allocations are provided to certain On-Floor DPMs and On-Floor LLMs. See Rules 6.45A(a)(i)(C) and 6.45B(a)(ii)(C). For pro-rata classes, the Market-Maker would receive a participation

market turner priority for participants that are first to improve CBOE's disseminated quote. In addition, a small order participation entitlement overlay for Designated Primary Market-Makers ("DPMs") and Lead Market-Makers ("LMMs") can be applied to each of the three allocation algorithms (i.e., price-time, pro-rata or UMA).⁶ These overlays are all optional.

The Exchange recently adopted another priority overlay for the price-time and pro-rata allocation algorithms that the Exchange refers to as the "modified participation entitlement."⁷ The modified participation entitlement currently operates in the same manner as the original participation entitlement(s) with a few exceptions. In particular, the modified participation entitlement provides that, if at the time of execution of an inbound order there are no Public Customer orders resting at the best price or a Public Customer was the first to rest interest at the best price, then the original participation entitlement(s) will be applied. In all other cases, participation entitlement and public customer priority overlays will not be in effect. This modified participation entitlement overlay is only applicable to automatic executions and is not applicable for auctions. Lastly, like the other priority overlays, the

that is the greater of its participation entitlement or its pro-rata allocation share. For price-time classes, the Market-Maker would receive a participation entitlement and a time priority share on any remaining balance. Whether UMA, pro-rata, or price-time priority is in effect for an options class, each allocation calculation is based on any remaining balance of the incoming order after public customer priority is applied, as well as after any other higher ranked priority overlay, such as market turner priority, is applied.

⁶ If the small order priority overlay is in effect for an option class, then orders for five (5) contracts or fewer will be executed first by the DPM or LMM, as applicable, appointed to the option class. This participation entitlement is subject to certain conditions, including a condition that public customer priority must be in effect in priority sequence ahead of the participation entitlement. See Rules 6.45A(a)(iii) and 6.45B(a)(iii).

⁷ Securities Exchange Act Release No. 60665 (September 14, 2009), 74 FR 4814 (September 21, 2009)(SR-CBOE-2009-052).

modified participation entitlement is optional. The Exchange can determine whether one or more of the priority overlays shall apply to an option class and if more than one is selected, the sequence in which they shall apply (consistent with applicable rules). All determinations are set forth in a regulatory circular.

Amendments to Market Turner and Modified Participation Entitlement Priority Overlays

The purpose of this rule change is to revise the market turner and modified participation entitlement priority overlays in various respects described below. First, currently the rules provide that the market turner priority overlay is only available for classes utilizing the price-time and pro-rata algorithms. The Exchange is now proposing to amend the rules to make this entitlement overlay available for classes utilizing any of the priority methods utilized by the Exchange.

Second, currently the modified participation entitlement overlay available for the price-time and pro-rata priority methods is only applicable to automatic executions of incoming electronic orders. It is not applicable to electronic auctions. The Exchange is also proposing to provide that the modified participation entitlement overlay would not be applicable for executions of incoming electronic orders initiated from PAR.⁸ Instead, as described in more detail below, the original participation entitlement parameters would be applied when PAR is used to initiate an execution of an electronic order.⁹ Thus, this outcome

⁸ PAR is utilized to accommodate trading in open outcry, where different rules on electronic book priority apply. For example, in open outcry at the same price, public customer orders in the electronic book have first priority, bid (offers) of in-crowd market participants have second priority, and bids (offers) of broker-dealer orders in the electronic book and electronic quotes of Market-Makers have third priority. See, e.g., Rules 6.45A(b) and 6.45B(b).

⁹ See note 10, infra.

would be no change from how the original participation entitlement(s) works today when PAR is utilized.

Third, currently the modified participation entitlement overlay available for the price-time and pro-rata priority methods only modifies the application of the original participation entitlement. It does not modify the application of the small order participation entitlement for DPMs and LMMs. The Exchange is proposing to provide that the modified participation entitlement overlay would also be available to modify the application of the small order participation entitlement.

Fourth, currently under the modified participation entitlement overlay available for options classes utilizing the price-time or pro-rata method, a participation entitlement(s) is only applied if there are no Public Customer orders resting at the best price or if a Public Customer was the first to rest interest at the best price. In all other cases, the participation entitlement and public customer priority overlays are not in effect for the allocation of incoming electronic orders.

The Exchange is proposing to replace this provision with what we refer to as the “greater than” provision. Under this provision, a Market-Maker that is the subject of a participation entitlement (including a small order participation entitlement) would only receive an entitlement if the amount the Market-Maker would be entitled to pursuant to the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm. In all other cases, the participation entitlement and public customer priority would not be applied. This allocation would be subject to the following:

- The Market-Maker's entitlement share would be calculated based on any remaining balance after all public customer orders at the best price are satisfied. For options classes using the pro-rata method, the Exchange may determine on a class-by-class basis to calculate the Market-Maker's entitlement share using the UMA methodology or the pro-rata methodology. For options classes using the price-time method, the Market-Maker's entitlement share would be calculated using the price-time methodology only.¹⁰
- When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, the participation entitlement and public customer priority overlays would not be considered. Instead the calculation would be based on a price-time or pro-rata basis, as applicable, and subject to any other applicable priority overlays, such as market turner priority.

The following example illustrates some outcomes when using CBOE's existing allocation algorithms and when using the proposed modified participation entitlement. Assume that an incoming electronic order for 24 contracts is received and that the following trading interest is represented at the execution price: three Market-Makers for 10 contracts each, the DPM for 40 contracts, and a public customer for 10 contracts.

¹⁰ This modified participation entitlement overlay would only be applicable to automatic executions and would not be applicable for executions of incoming electronic orders initiated from PAR or from electronic auctions. Instead, the original participation entitlement parameters would be applied for PAR and electronic auctions. In pro-rata classes where the UMA method is selected to calculate the Market-Maker's modified participation entitlement share, executions of incoming electronic orders initiated from PAR and electronic auctions would be allocated using the UMA method. Therefore, in such classes, the Market-Maker's original participation entitlement share of a PAR or electronic auction execution would be calculated using the UMA method.

- In a class where the algorithm is simply pro-rata, each Market-Maker is allocated 3 contracts, the DPM is allocated 12 contracts, and the public customer is allocated 3 contracts.
- In a class where the algorithm is pro-rata with original DPM entitlement and public customer priority overlays, the public customer is allocated 10 contracts, the DPM is allocated 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70), and each Market-Maker is allocated 2 contracts.
- In a class where the algorithm is pro-rata with the proposed modified DPM entitlement overlay (and the DPM entitlement is calculated based on the pro-rata method), the allocation would be simple pro-rata because the DPM's pro-rata share of 12 contracts (24 contracts * pro-rata share of 40/80) is greater than the DPM's entitlement share of 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70). Therefore, each Market-Maker would be allocated 3 contracts, the DPM would be allocated 12 contracts, and the public customer would be allocated 3 contracts.
- In a class where the algorithm is pro-rata with the proposed modified DPM entitlement overlay (and the DPM entitlement is calculated based on UMA using a 0% Component A weighting and a 100% Component B weighting),¹¹ the allocation would be simple pro-rata because the DPM's pro-rata share of 12 contracts (24 contracts * pro-rata share of 40/80) is greater than the DPM's UMA

¹¹ For purposes of this example, assume that the original DPM participation entitlement is based on the greater of the amount the DPM would be entitled to pursuant to the participation entitlement or the amount it would otherwise receive pursuant to the operation of the UMA algorithm. See note 5, supra.

entitlement share of 8 contracts (14 contracts remaining after the public customer order * greater of 30% or 40/70). Therefore, each Market-Maker would be allocated 3 contracts, the DPM would be allocated 12 contracts, and the public customer would be allocated 3 contracts.¹²

As illustrated above, the outcomes that would result when the modified participation entitlement is activated in a class are not novel or unique. Each outcome is an allocation that is currently permitted under CBOE's existing allocation rules. Specifically:

- for classes using a price-time methodology, the resulting allocation would be either a simple price-time allocation or a price-time allocation with a participation entitlement after yielding to all public customer orders at the best price; and
- for classes using a pro-rata methodology, the resulting allocation would be either a simple pro-rata allocation, a pro-rata allocation with a participation entitlement after yielding to all public customer orders at the best price or, if applicable, an UMA allocation with a participation entitlement after yielding to all public customer orders at the best price.

Put another way, the allocation that occurs when a modified participation entitlement is applied would be no change from how the allocation operates under the existing rules for a class utilizing the original participation entitlement (and small order participation entitlement). Specifically, if the amount the Market-Maker would be entitled to pursuant to

¹² As another example, assume that an incoming electronic order for 4 contracts is received and that the following trading interest is represented at the execution price: three Market-Makers for 10 contracts each, the DPM for 40 contracts, and a public customer for 10 contracts. In a class where the algorithm is pro-rata with the proposed modified participation entitlement for small orders, the allocation would be simple pro-rata because the DPM's pro-rata share 2 contracts (4 contracts * pro-rata share of 40/80) is greater than the DPM's small order preference entitlement share of 0 contracts (0 contracts remaining after the public customer order * 100%).

the participation entitlement is greater than the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, then the participation entitlement allocation share will continue to be calculated based on any remaining balance of the incoming order after public customer priority and any other priority overlay ranked ahead of the entitlement. When calculating the amount the Market-Maker would otherwise receive pursuant to the operation of the algorithm, the resulting allocation would be no change from how the allocation would operate under the existing rules for a class utilizing a simple price-time or pro-rata algorithm. Specifically, the Hybrid System will calculate the Market-Maker's price-time or pro-rata share, as applicable, without regard to any public customer priority or participation entitlement priority (because public customer priority would not be applied when a participation entitlement is not applied). Any other higher ranked priority overlays, such as market turner priority, will be considered in determining the balance of the incoming order to be allocated under the price-time or pro-rata algorithms, as applicable.

The notion of a "greater than" concept for determining the participation entitlement amount is also not novel or unique.¹³ The primary distinction with the instant proposal is that, under the original participation entitlement, public customer priority must be applied in a priority sequence ahead of the participation entitlement at all times for the entitlement to be in effect. Under the modified participation entitlement, public customer priority will not be

¹³ For example, a CBOE Market-Maker gets the greater of its UMA share (price-time or pro-rata share, if applicable) or entitlement share. See CBOE Rules 6.45A(a)(i) and (ii) and 6.45B(a)(i) and (ii). On NYSE Arca, Inc. ("Arca"), an LMM or directed option market maker ("DOMM") gets the greater of its price-time share or, subject to public customer priority, entitlement share. See Arca Rule 6.76A(a). On the International Securities Exchange, LLC ("ISE"), an primary market maker or preferred market maker gets the greater of its pro-rata share or entitlement share, which is applied after priority customers but based on the total order size (as opposed to size remaining after priority customers are satisfied). See ISE Rule 713.01 and .03.

“hardcoded” into the algorithm methodology – instead the participation entitlement and public customer priority will only be applied if the entitlement share is greater than the price-time or pro-rata share, as applicable, and subject to any other applicable priority overlays, such as market turner priority. This distinction itself is not entirely novel or unique. In this regard, the Exchange notes, for example, that the price-time algorithm being proposed is substantially similar to what currently exists on at least one other options exchange, except that CBOE would propose to yield to all public customer orders at the same price when a Market-Maker participation entitlement is applied (not just public customer orders received in time sequence ahead of the Market-Maker receiving the entitlement).¹⁴

The Exchange notes that the Commission has stated that priority of public customer orders is not an essential attribute of an exchange and in the past the Commission has approved trading rules at options exchanges that do not give priority to public customers that are priced no better than the orders of other market participants.¹⁵ Indeed, the Exchange’s price-time and pro-rata methodologies discussed above are examples of allocation methodologies that do not require public customer priority. However, when an entitlement applies (such as the Market-Maker participation entitlement or a crossing entitlement), the Commission has had a general policy for the options exchanges to require yielding to all public customers at the same price before the entitlement can be applied.¹⁶ CBOE’s proposed amendments to the modified participation entitlement are entirely consistent with

¹⁴ See, e.g., Arca Rule 6.76A(a).

¹⁵ See Securities Exchange Act Release No. 61198 (December 17, 2009), 74 FR 68880 (December 29, 2009)(SR-CBOE-2009-078).

¹⁶ See, e.g., CBOE Rules 6.45A, 6.45B, 6.74, 6.74A and 6.74B, and ISE Rules 713, 716 and 723. Arca Rule 6.76A(a) is a slight exception because it only requires yielding to public customers at the same price that have time priority over the LMM or DOMM.

this policy objective – before any entitlement can be applied, all public customer orders at the best price must be satisfied. There is no requirement that public customer priority be “hardcoded” on every allocation, only those allocations where an entitlement is applied.¹⁷

The Exchange believes that public customers will be treated equitably and fairly under the proposed rule change. We are proposing to apply a general allocation algorithm where all market participants are treated equally (i.e., price-time or pro-rata, as applicable, and subject to any other applicable priority overlays, such as market turner priority) and, to the extent a Market-Maker participation entitlement is applied, to apply the entitlement only after all public customer orders at the same price have been satisfied. The proposed amendments to the modified participation entitlement do not serve to in any way disadvantage public customers or advantage other market participants over public customers. In fact, the proposed amendments actually favor public customers because they receive an added benefit if any entitlement is applied (i.e., they are completely satisfied with a 100% fill) when public customers would otherwise only receive a price-time or pro-rata share like any other market participant. Moreover, the Exchange believes that the modified participation entitlement, as amended, would encourage quote competition because is designed to reward aggressive pricing by offering incentives both for Market-Makers to support and participate in the CBOE marketplace and for market participants to establish the best price or quote at the best price with size. In classes utilizing a price-time algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by establishing the best price. In classes utilizing a pro-rata algorithm

¹⁷ Arca’s price-time and LMM/DOMM entitlement is one example. See, e.g., Arca Rule 6.76A(a). CBOE’s price-time or pro-rata and existing modified participation entitlement are other examples. See CBOE Rules 6.45A(a)(ii)(3) and 6.45B(a)(i)(3).

with a modified participation entitlement, all market participants (including public customers) are incented to compete by quoting more size.

With each incoming electronic order, public customers can expect to receive their respective price-time or pro-rata share (same as other market participants) or, in some cases, a 100% fill.¹⁸ To the extent that public customers may strategically rest orders based on the allocation algorithm employed at a given exchange,¹⁹ public customers can adjust their “quoting” behavior accordingly, similar to how they and other market participants already would do today. Several market characteristics factor into a market participant’s quoting behavior including, but certainly not limited to, the applicable fee structure, average incoming order size, and the average touch rate (*i.e.*, average allocation a market participant actually receives on incoming electronic orders). The allocation for any market participant (including public customers) changes constantly from order-to-order, second-to-second for various reasons. For instance on CBOE the ultimate allocation depends upon, among other things, the size of an incoming order and whatever trading interest happens to be represented at the time the order is received (*e.g.*, one second only public customers may be represented at the best price, in which case the allocation to an individual customer is based on time priority; the next second there may be one public customer and multiple market makers at the

¹⁸ That the Exchange may use a pro-rata or UMA methodology to determine the Market-Maker’s entitlement percentage does not have any impact from the public customer’s perspective. The public customer either gets a pro-rata share or a 100% fill. See, e.g., notes 11 and 12, supra, and surrounding discussion.

¹⁹ The Exchange believes that public customers that are traditional retail investors do not typically enter resting orders based on allocation algorithms, so this change will not impact them. To the contrary, public customers actually benefit from the proposed allocation methodology because they get a minimum price-time or pro-rata share and, sometimes, a 100% fill before other market participants. Voluntary Professional and Professional customers are treated the same as broker-dealers (not public customers) under CBOE’s allocation rules. See Rule 1.1(fff) and (ggg).

best price, in which case the allocation to the customer is based on customer priority regardless of when the customer entered the order and to the other market-makers based on a price-time (or pro-rata or UMA share, if applicable) and any applicable entitlement share; a few seconds later there may be a market-turner, in which case the market turner trades first either entirely or based on a percentage share, then public customers at the best price trade based on time priority; the next second there may be only one public customer at the best price and incoming order takes out the entire balance of the resting order).

In determining their desired quote size and price, other market participants already account for the existence or non-existence of a Market-Maker entitlement (the entitlement may or may not be applied on an order-by-order basis and to different degrees under the current rules depending on, for example, whether a Market-Maker with an entitlement is actually quoting at the best price, the size of the Market-Maker's quote, the number of other Market-Makers quoting at that price, and the size of the incoming order). Under the proposed rule change, public customers that may adjust their quoting dynamics based upon, among other things, the applicable allocation algorithm may also want to account for the existence or non-existence of a Market-Maker entitlement, similar to how other market participants would already do today.²⁰

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act²¹ and the rules thereunder, and in particular with: Section 6(b)(5) of the Act,

²⁰ For example, the impact of the proposed rule change would be reflected in a customer's average touch rate, which the customer might then use to determine size and price when entering orders.

²¹ 15 U.S.C. 78f(b).

which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for 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;²² and Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or in furtherance of the Act.²³ The proposed rule change ensures that incoming electronic orders are allocated in an equitable and fair manner and that all market participants (including public customers) have a fair and reasonable opportunity for allocations based on established criteria and procedures. CBOE believes that the change will allow the Exchange other methods to reward aggressive pricing in options trading on the Hybrid System by making market turner available for classes utilizing any of the priority methods utilized by the Exchange. CBOE also believes that the modified participation entitlement, as amended, would encourage quote competition because is designed to reward aggressive pricing by offering incentives both for Market-Makers to support and participate in the CBOE marketplace and for market participants to establish the best price or quote at the best price with size. In classes utilizing a price-time algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by establishing the best price. In classes utilizing a pro-rata algorithm with a modified participation entitlement, all market participants (including public customers) are incented to compete by quoting more size.

²² 15 U.S.C. 78f(b)(5).

²³ 15 U.S.C. 78f(b)(8).

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 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 self-regulatory organization consents, the Commission will:

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

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

IV. Solicitation of Comments

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

Electronic comments:

Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2010-038 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2010-038. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2010-038 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁴

Dated: _____

Florence E. Harmon
Deputy Secretary

²⁴ _____
17 CFR 200.30-3(a)(12).