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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68504; File No. SR-CBOE-2012-122)

December 20, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change Related to SPX Combo Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 6, 2012, the Chicago Board Options Exchange, Incorporated (“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 is proposing to amend its procedures for trading SPX Combo Orders. The text of the rule proposal is available on the Exchange’s website (<http://www.cboe.org/legal>), at the Exchange’s Office of the Secretary 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, 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

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

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

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 Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend CBOE Rule 24.20, SPX Combination Orders, to adopt a one-year pilot program containing revised procedures that the Exchange believes would make the trading of certain combination orders in S&P 500 Index option contracts (SPX) more competitive with the trading of combinations in S&P 500 Index futures contracts traded on the Chicago Mercantile Exchange ("CME"). As discussed further below, the Exchange is also proposing to revise the existing SPX Combo Order text to make certain clarifying amendments.

Background

When SPX traders and customers trade SPX options, they hedge their underlying risk with either S&P 500 Index futures traded at CME or with SPX call and put options traded as combinations at CBOE (for purposes of this discussion, a "combination" is an order involving a number of call option contracts and the same or equivalent number of put option contracts in the same underlying security).<sup>3</sup> In order for SPX traders and customers to hedge the risk of their

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<sup>3</sup> See CBOE Rule 6.53(e). A combination is a long combination when it combines a long call and a short put on the same series, and it is a short combination when it combines a short call and a long put of the same series. An options position can be hedged by trading the number of combinations equivalent to the delta of the particular option multiplied by the number of options in the transaction. The "delta" is the number of SPX combinations required to establish a market neutral hedge based on the value of the underlying S&P 500 Index futures contract. See CBOE Rule 24.20(a)(2). For example, a customer that purchases 100 SPX calls that have a delta of 30 (expressed as 30% or .30) may hedge against a downward movement in the S&P 500 Index by either selling S&P 500 Index futures on the CME or by trading short SPX combinations. If combinations are used to hedge, the customer will need to trade 30 short combinations (.30 X 100). The appropriate ratio of combinations in this example is to sell 30 SPX calls and buy 30 SPX

options positions using S&P 500 futures, they have to execute two separate trades in two separate markets.

*Example 1:* Assume a trader or customer wants to buy the SPX April 1335 puts and hedge with the April futures contract trading at 1350. First, the SPX April 1335 put option position would be traded at CBOE. After the options trade, the trader or customer then has to submit an order to CME to trade the appropriate number of S&P 500 Index April futures contracts to hedge the options trade.

*Example 2:* Assume a trader or customer wants to trade a conversion involving the purchase of the SPX April 1335 puts and the sale of the SPX April 1335 calls with the purchase of the April futures contract trading at 1350. First the SPX April 1335 put-call option position would be traded on CBOE. After the options trade, the trader or customer then has to submit an order to CME to trade the appropriate number of S&P 500 Index April futures contracts to hedge the options trade.

Hedging SPX options by using S&P futures in this manner is not preferred by traders and customers because of the execution risk that is involved in having to trade in two separate markets. In other words, the trader or customer is exposed to the risk of the S&P 500 Index moving significantly before the hedging futures transaction can be executed (e.g., assume the trader or customer in *Example 1* above completes the purchase of the SPX April 1335 puts but the S&P 500 Index declines sharply before the futures can be traded. Given the market decline, the trader or customer must sell the futures at a much lower price to complete the hedge.) As a result, SPX traders and customers prefer trading SPX combinations against their SPX options positions in order to hedge the risk associated with those positions.

*Example 3:* Assume the S&P 500 Index April futures contract is trading at 1350 and a customer wants to trade the 30 delta SPX April 1335 puts tied to the April 1350 calls and April 1350 puts (instead of the April futures contract). Under this scenario, all three legs of the strategy would be traded on CBOE.

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puts with the same strike price and expiration date. If futures are used to hedge, the customer will need to sell 12 S&P 500 Index futures on the CME ( $(.30 \times 100)/2.5 = 12$ ), where 2.5 is the multiplier used to convert SPX options positions to the equivalent S&P 500 Index futures position (one S&P 500 Index future equals 2.5 SPX combinations).

*Example 4:* Assume a trader or customer wants to trade a conversion involving the purchase of the SPX April 1335 puts and the sale of the SPX April 1335 calls tied to the April 1350 calls and April 1350 puts (instead of the April futures contract). Under this scenario, all four legs of the strategy would be traded on CBOE.

One reason that the use of combinations by SPX traders and customers is preferred is obviously that all the required transactions can be effected as a package in one market, CBOE. Hedging options with combinations avoids the execution risk and the increased costs involved in trading in the futures market. Another reason that the use of combinations is preferred is that an options order can be “tied” to a particular level of the S&P 500 Index in order to establish the hedge price.<sup>4</sup> When SPX options are tied to SPX combinations, the underlying hedge level of the S&P 500 Index is established and traders and customers can determine the exact implied volatilities of their options trades.<sup>5</sup> Hedging options with combinations acts as an incentive for market-makers to reduce the price width of their markets because they know that their hedge

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<sup>4</sup> Using the example in note 3, *supra*, the customer will request a market for the calls that the customer wishes to purchase based on a specified level of the S&P 500 Index. The customer specifies an underlying level of the S&P 500 Index to allow market participants to determine the delta (in this case 30) and a theoretical value of the calls. A market participant will then give his or her market for the 30 delta calls and for the component call and put options that will make up the combination. The combination portion of the order is equivalent to an order to trade futures at the underlying value of the S&P 500 Index that has been specified by the parties. The prices quoted for the call and put components of the combination establish the hedge price for the transaction. When the foregoing occurs, SPX traders and customers say that the calls have been “tied” to the combination or “tied to the combo.”

<sup>5</sup> Implied volatility is defined as the volatility percentage that justifies an option's price. When the customer and the market-maker establish the underlying hedge level of the S&P 500 Index and a market price for the calls, the market-maker and the customer are able to use option pricing models to determine the implied volatility of the calls. Knowing the implied volatility that is being quoted in the market is useful to customers and traders in that customers and traders frequently take positions in the market based on the implied volatility level.

price has been established and they will not have to trade in another market. Thus, customers who trade options tied to combinations enjoy tighter and more liquid markets.

Occasionally, certain market activity occurs that makes it difficult to effect these types of trades. If an order for options tied to a combination receives an initial quote but does not trade immediately, it remains a live order until the party that submitted the order cancels it. The order may not trade immediately for any reason, but some of the more common reasons are that the customer submitting the order may want to show the order to other market participants in order to improve the initial quote received, or a Trading Permit Holder (“TPH”) may need time to locate a customer that it believes might like to participate in the trade. Specific market activity can occur hours after an order for options tied to a combination is submitted and initially quoted that would make the trade desirable to both the customer and the market-maker to consummate. However, in a volatile market, the underlying index can move substantially in one direction such that the originally quoted prices for the options and the combinations are no longer within the current market quotes. In such market conditions, the parties would be unable to consummate the trade because CBOE Rules preclude trading the legs of the options and a combination strategy outside of the currently prevailing market quotes in the individual component series legs.<sup>6</sup> Certain relief currently applies in the case of an SPX Combo Order executed pursuant to CBOE Rule 24.20 (the term “SPX Combo Order” is defined and discussed in more detail below). However, this relief is limited and not near [sic] as accommodating as the rules for trading spreads and combinations on the futures markets. Thus, when it comes to the existence of rule constraints that may prevent complex, multi-part strategy trades from occurring out-of-range

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<sup>6</sup> See, e.g., CBOE Rules 6.45B(b)(ii) and 6.53C.

from the prevailing market quotes in the individual component series legs, another significant consideration for SPX traders and market participants is the ease with which an execution can take place on other markets such as the CME, which offers a comparable alternative to SPX but is not subject to the same constraints as a national securities exchange like CBOE.

In that regard, CBOE Rule 24.20 was adopted in 2002 to enable the Exchange to better compete with futures exchanges such as the CME.<sup>7</sup> The purpose of the rule is to permit the trading of out-of-range “SPX Combo Orders” under certain, limited circumstances. In essence, the rule sets forth a procedure that allows for an SPX Combo Order to be executed and reported up to 2 hours after the order is originally quoted, at the prices originally quoted. Specifically, for purposes of the rule, an “SPX Combo Order” is narrowly defined to be an order to purchase or sell SPX options and the offsetting number of SPX combinations defined by the delta. An “SPX combination” is defined [sic] a long SPX call and a short SPX put having the same expiration date and strike price (contrast this to the general definition of a “combination” noted

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<sup>7</sup> Originally, the Exchange had considered modeling a CBOE rule after CME Rule 542 (discussed in more detail below). However, the Exchange ultimately settled on a proposal that would have allowed a CBOE TPH (referred to as a “member” at the time) to execute an SPX Combo Order immediately or at any time thereafter during the trading day at the prices originally quoted for each of the component option series. Thus, the originally quoted prices would have had to have been within the current market at the time of the original quote, but a trade could be executed and reported at any time thereafter during the trading day. This proposal was noticed for comment in October 2000. Although there were no comments on the proposal, the Exchange submitted several amendments to the rule filing in order to, among other things, add a definition of an “SPX Combo Order,” provide that if the execution does not occur at the current market prices originally quoted it may only be executed up to 2 hours after the time of the original quote, clarify that each component leg of an SPX Combo Order would be reported using an indicator, and to include additional information concerning the need for the proposal. The proposal, as modified, was ultimately approved in February 2002. See Securities Exchange Act Release Nos. 43452 (October 17, 2000), 65 FR 63658 (October 24, 2000)(SR-CBOE-00-40) and 45389 (February 4, 2002), 67 FR 6291 (February 11, 2002)(SR-CBOE-00-40).

above). A “delta” is defined as the positive (negative) number of SPX combinations that must be sold (bought) to establish a market neutral hedge with an SPX option position. Under the rule, when a TPH holding an SPX Combo Order and bidding or offer [sic] in a multiple of the minimum increment on the basis of a total debit or credit for the order has determined that the order may not be executed by a combination of transactions with the bids and offers displayed in the SPX limit order book or by the displayed quotes of the crowd, then the SPX Combo Order may be executed at the best net debit or credit so long as (i) no leg of the SPX Combo Order would trade at a price outside the currently displayed bids or offers in the trading crowd or bids and offers in the SPX limit order book; and (ii) at least one leg of the SPX Combo Order would trade at a price better than the corresponding bid or offer in the SPX limit order book (which consists of public customer orders).<sup>8</sup> If the SPX Combo Order is not executed immediately, the rule provides that, notwithstanding any other rules of the Exchange, the SPX Combo Order may be executed and printed outside the current market quotes and at the prices originally quoted for each component series within 2 hours after the time of the original quotes (the Exchange refers to this as the “2-hour window” procedure).

*Example 5:* Assume the S&P 500 Index April futures contract is trading at 1350 and a customer wants to trade the 30 delta SPX April 1335 puts tied to the April 1350 calls and April 1350 puts. The TPH holding the customer’s SPX Combo Order receives an original quoted market at 9:35 a.m. (all times are Chicago time). The TPH can execute that SPX Combo Order any time up to 11:35 a.m. at the prices originally quoted (even if the prices are out-of-range from the current display market at the time the trade is later executed and reported).<sup>9</sup>

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<sup>8</sup> Stated another way, this provision provides that, if there are resting public customer orders on all of the legs of the individual series of the strategy, at least one leg of the order must trade at a price that is better than the corresponding bid or offer.

<sup>9</sup> For purposes of the example, assume the 30 delta SPX April 1335 put is bid \$6.00 and offered \$6.20, and the SPX April 1350 call and April 1350 put are each bid \$12.00 and offered \$12.30. The TPH agrees to buy 100 of the 1335 puts at \$6.20 and, to hedge these, agrees to buy 30 April 1350 calls at \$12.00 and to sell 30 April 1350 puts at \$12.00 (30 “long” combinations). Before the orders can be executed, assume that the market

As noted above, this procedure allowing for a 2-hour window for trade execution and reporting was adopted in order to allow the Exchange to try to compete on a more level field with the CME, where the trading of S&P 500 Index futures contracts is conducted under much more liberal trading rules designated to facilitate complex, multi-part order executions. By comparison, CME rules provide that a spread or combination can trade without regard to the current market prices so long as each of the respective legs of the spread or combination transaction is priced within the daily price limits for those contracts that have price limits. In the case of the S&P 500 Index futures contract, the daily limit is a 5 percent upside and downside price limit based on the prior day's settlement price.<sup>10</sup> In essence, CME has a market for complex, multi-part order strategies that is entirely separate from its market for simple order strategies and is bound only by the daily limit.

*Example 6:* A CME trader wants to execute an S&P 500 Index futures contract combination order strategy at 9:35 a.m. (or 9:36 a.m., or 11:35 a.m., or any other time throughout the regular trade day session). The trader can execute the order at any net price so long as each respective leg price does not exceed 5 percent of the upside/downside price limit based on the prior day's settlement price.

From CBOE's perspective, the SPX Combo Order rule for options does not come close to leveling the field with the CME rule for spread and combination trading. CBOE's rule still

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rallies to a new futures level of 1355. The April 1350 call is now trading at \$15, the April 1350 put at \$10 and the April 1335 put at \$ 4.75. Normally the TPH would not be able to execute the strategy because the component legs would trade out-of-range of the current displayed market. However, existing CBOE Rule 24.20 permits an execution at the prices originally quoted (\$6.20 and \$12 in the respective series) because the options would not have traded outside the displayed bids or offers originally quoted in the crowd and book (\$6 bid, \$6.20 offered; \$12 bid, \$12.30 offered).

<sup>10</sup> See, e.g., CME Rule 542, Simultaneous Spread and Combination Transactions; see also CME Rule 35102.I, Price Limits, Trading Halts, and/or Trading Hours [sic] (which contains information on the daily price limits for S&P 500 Index futures contracts).

requires an SPX Combo Order to be executed at the prices originally quoted, it just gives a two-hour window to find liquidity and complete the execution. By comparison, the CME rule allows spread and combination executions to take place without regard to market prices and only be bound by the daily limit. Under these competing frameworks, it can be more difficult for a CBOE market participant attempting to achieve an execution of a complex SPX option trading strategy compared to a CME market participant attempting to achieve an execution of substantially the same strategy using S&P 500 Index futures contracts. While this distinction is particularly exacerbated during times of market volatility, it can also be an issue at other times as well. In addition, the Exchange believes market participants who are looking to frequently trade spreads or combinations, in general, or as a strategy for hedging risk, in particular, would tend to utilize a market venue where they can more consistently depend on achieving a net price execution at all times – regardless of the level of market volatility – which can put CBOE at a competitive disadvantage. The additional burden placed on CBOE market participants can have the effect of discouraging trading on CBOE in favor of trading on the CME. The Exchange believes this competitive disadvantage is not consistent with just and equitable principles, serves as an impediment to a free and open market, and may ultimately not serve investors or the public interest. In order to compete and more effectively achieve certain strategy executions, as well as manage risk, the Exchange believes that market participants need more comparable procedures within the CBOE Rules.

### Proposal

The Exchange is now seeking to amend its SPX Combo Order procedures on a pilot basis in an attempt to further level the field of competition between market participants trading on CBOE and CME. In particular, the Exchange is now proposing to replace the existing 2-hour

window procedure (which allows a trade within 2 hours after the original quotes) with a new 2-hour window procedure (which would allow a trade to take place so long as it would have been in the permissible net price trading range within the preceding 2 hours) on a one-year pilot basis.

The new 2-hour window procedure would be reflected in proposed new Interpretation and Policy .01 to Rule 24.20, which would replace the existing 2-hour window procedure reflected in existing Rule 24.20(b)(2), for a pilot period ending one-year after this rule change filing is approved. The new Interpretation and Policy would provide that, notwithstanding any other rules of the Exchange, an SPX Combo Order may be transacted in open outcry in the following manner: A TPH holding an SPX Combo Order may execute the order at the best net debit or credit price, which may be outside the current derived net market so long as (i) the best net debit or credit price would have been at or within the derived net market over the preceding 2 hours of trading that day, (ii) no leg of the order would trade at a price outside the displayed bids or offers in the trading crowd or in the SPX limit order book (which contains public customer orders) for that series at a point in time over the preceding 2 hour period, and (iii) at least one leg of the order would trade at a price that is better than the corresponding bid or offer in the SPX limit order book (which contains public customer orders) at the same point in time over the preceding 2 hour period.<sup>11</sup> The “derived net market” will be defined as the Exchange’s best bids and offers displayed in the individual option series legs for the strategy at any one point in time.

*Example 7:* Assume the S&P 500 Index April futures contract is trading at 1350 and a TPH wants to trade the 30 delta SPX April 1335 puts tied to the April 1350 calls and April 1350 puts. Assume the TPH wants to buy 100 SPX April 1335 puts at \$6.20 tied to

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<sup>11</sup> Stated another way, this provision provides that, if there are resting public customer orders on all of the legs of the individual series of the strategy at the same point in time, at least one leg of the order must trade at a price that is better than the corresponding bid or offer.

a purchase of 30 April 1350 calls at \$12 and sale of 30 April 1350 puts at \$12 at 9:35 a.m. At the time, assume the current displayed market for the April 1335 puts is \$6.00 - \$6.20, for the April 1350 calls is \$12.10 - \$12.50, and for the April 1350 puts is \$12.10 - \$12.50. As a result, the SPX Combo Order is priced “out-of-range” from the current derived net market (\$12 is outside the \$12.10 bid, \$12.50 offered markets for the April 1350 calls and April 1350 puts). The TPH can execute the SPX Combo Order at the desired net price so long as it is the best net price and the net price would have been in range over the preceding 2 hours of trading that day. In particular, the net price must be at or within the derived net market price range over the preceding 2 hours of trading that day, each component series leg must trade at a price at or within the displayed bids or offers at a point in time over the preceding 2 hour period, and at least one leg must trade at a price that is better than the corresponding bid or offer in the SPX limit order book at the same point in time. (In this particular example, the derived net market range would be based on the markets that existed from 8:30 a.m. – 9:35 a.m., since the market was open for less than 2 hours). Assume, for example, if the displayed market at 9:20 a.m. for the April 1335 puts was \$5.90 - \$6.30, for the April 1350 calls was \$12.00 - \$12.60, and for the April 1350 puts was \$12.00 - \$12.60 and there are not public customer orders displayed at the best price in all of the component series, then the SPX Combo Order could be executed at the desired net price because it would have been net priced at or within the derived net market over the preceding two hours of trading, the individual component leg prices are at or within the displayed component series prices, and at least one leg would trade at [sic] price that improves corresponding public customer orders in the SPX limit order book.

It should be noted that the derived net market would be calculated based on the displayed prices in each of the component series that exist at a single point in time over the preceding 2-hour window, not separate points in time for each series (e.g., a TPH cannot use the prices of the April 1335 puts at 9:20 a.m. and the prices of the April 1350 calls and puts at 9:30 a.m. to calculate a derived net market). The net execution price must have been “in range” over the prior 2-hour window of trading. To be “in range,” as noted above, the net price must have been at or within the derived net market over the preceding 2-hour period, and each leg of the order must “line up” and trade at a price that would have been at or inside the best bids and offers displayed in the individual option series legs at a single point in time over the 2-hour window and at least one leg must trade at a price that is better than corresponding public customer orders in the SPX limit order book at the same point in time.

This procedure is generally modeled after CME Rule 542 (e.g., an SPX Combo Order may be executed out-of-range from the current market prices in the individual component option series legs), except that under CBOE's proposed pilot the reported net price and related component series prices must [sic] in range within the preceding 2 hours. By comparison, the CME rule only requires the reported price of each component futures contract leg to be within the daily limit price (a number that is, by definition, generally much wider than the 2-hour derived net market range proposed by CBOE).

As is the case for the existing SPX Combo Order trading procedure today, SPX Combo Orders executed under the proposed new pilot procedure would continue to be identified with a special indicator on each component leg that would be price reported to the trading floor and the Options Price Reporting Authority ("OPRA"). This indicator acts as notice to the public that the reported prices are part of an SPX Combo Order trade. Therefore, the Exchange believes that price discovery should not be adversely affected by the operation of CBOE Rule 24.20, as proposed to be modified. In addition, as is the case today, the proposed procedure under CBOE Rule 24.20 would not lessen the obligations of TPHs to obtain best execution of options orders for their customers. Therefore, with the approval of the proposed rule change, CBOE will issue a regulatory circular to its TPHs explaining the operation of CBOE Rule 24.20, as amended. In the regulatory circular, CBOE will remind TPHs that CBOE 24.20 does not lessen the obligation of TPHs to obtain best execution of options orders for their customers.

If the Exchange were to propose an extension of the proposed pilot program, or should the Exchange propose to make the program permanent, the Exchange would submit, along with any filing proposing such amendments to the program, a pilot program report that would provide an analysis of the program covering the period during which the program was in effect. This

report would include information on the number of SPX Combo trades and best bid or offer trade through/trade at analysis of such SPX Combo trades. The report will also include information on the SPX options class and other broad-based index option products, including information on average contract value, average daily volume, open interest, average order size, percentage of complex orders, percentage of volume from complex orders, and average daily notional value traded. The report would be submitted to the Commission at least two months prior to the expiration date of the pilot program and would be provided on a confidential basis.

The Exchange believes the proposed pilot procedure will facilitate the orderly execution of SPX Combo Orders at all times, including during volatile markets, in a manner that is more competitive with the existing CME process. In addition, the Exchange believes the proposed pilot procedure will continue to address customers' desire to show an order to other market participants to seek price improvement or additional liquidity. The Exchange also believes the proposed pilot procedure will continue to create an incentive for market-makers to reduce the price width of their markets because they know that their hedge price has been established and they will not have to trade in another market. Thus, customers who trade options tied to combinations will continue to enjoy tighter and more liquid markets

In proposing to introduce this pilot, CBOE is cognizant of the need for market participants to have substantial options transaction capacity and flexibility to hedge their trading activity in SPX, on the one hand, and priority principles common to securities exchanges, on the other. CBOE is also cognizant of the CME market, in which similar restrictions do not apply. In light of these considerations, CBOE believes the proposed pilot procedure is appropriate and reasonable and would provide market participants with additional flexibility in achieving desired SPX Combo Order strategies and in determining whether to execute their options on CBOE or a

comparable product on CME. In that regard, the Exchange notes that the proposed new procedure outlined above does not go as far as what exists today on CME and instead represents what the Exchange believes is only an incremental change to an existing trading process that is already very narrowly tailored. For the foregoing reasons, CBOE believes that the proposed pilot procedure for trading SPX Combo Orders is reasonable and appropriate, would promote just and equitable principles of trade, and would facilitate transactions in securities while continuing to foster the public interest and investor protection.

The S&P 500 Index is widely regarded as the best single gauge of investable U.S. equities. There is over \$4.83 trillion benchmarked to the index, of which index assets comprise approximately \$1.1 trillion. The index includes 500 leading companies with an aggregate market capitalization of \$12.4 trillion, which represents approximately 80% of the available market capitalization of all U.S. equities.<sup>12</sup> Aggregate trading activity in S&P 500 component securities averages 2.7 billion shares per day, roughly four times the aggregate average daily volume of components of the Nasdaq-100, Russell 2000 Indexes and the Dow Jones Industrial Average.

The S&P 500 serves as the underlying interest for the most liquid and actively-traded derivatives contracts globally, in both listed and over-the-counter markets. As a result, S&P 500 index derivatives are widely recognized, and used, by institutional investors as efficient and cost-effective tools to quickly gain or reduce exposure to U.S. equities. The average order size in SPX options of 152 contracts, for instance, represents an economic exposure of over \$20 million. CBOE estimates that activity in over-the-counter S&P 500 contracts is between 4 to 6 times the

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<sup>12</sup> See <http://us.spindices.com/indices/equity/sp-500>. In comparison, the aggregate market capitalization [sic] other popular broad-based indexes are: Nasdaq-100 Index - \$2.9 trillion, Russell 2000 Index – \$1.3 trillion and the Dow Jones Industrial Average – \$3.8 trillion.

size of listed activity, yet competition among dealers typically results in narrower spreads than comparable over-the-counter (“OTC”) instruments overlying other leading U.S. equity benchmarks.

As shown in the following table, trading activity and open interest in listed S&P 500 derivative contracts is at least ten times the activity and open interest of other leading broad-based index contracts in terms of both contracts and notional value.<sup>13</sup>

	<b>Avg. Daily Volume (ADV)</b>	<b>% ADV</b>	<b>Avg. Daily Notional Value (\$Millions)</b>	<b>% Avg. Daily Notional Value</b>	<b>Open Interest (10/31/12)</b>	<b>% Open Interest</b>
<b>S&amp;P 500 Index</b>	2,793,369	82%	\$253,003	84%	18,133,151	89%
<b>Nasdaq-100 Index</b>	297,295	9%	\$24,457	8%	867,724	4%
<b>Russell 2000 Index</b>	205,087	6%	\$16,489	5%	1,078,110	5%
<b>Dow Jones Industrial Average</b>	128,435	4%	\$8,140	3%	354,232	2%
<b>TOTAL</b>	3,424,187		\$302,089		20,433,217	

Cash-settled SPX options and S&P 500 futures and futures options account for 2.8 million contracts per day, or 82% of the average daily volume traded in the leading equity index contracts. Additionally, S&P 500-based derivatives account for over \$250 billion average daily notional value traded, or 84% of average daily notional in the leading index contracts. Open interest in S&P 500 index contracts as of October 31, 2012 was over 18 million contracts with a notional value of over \$2 trillion, which is ten times greater than the open interest in the other leading index contracts combined.

<sup>13</sup> “Notional Value” is the product of contracts times contract multiplier times underlying index value.

The transparency and liquidity of S&P 500 index options has given rise to substantial activity in volatility trading. CBOE understands that equity volatility trading globally is predominantly based on 3 indexes: S&P 500 Index (U.S.), EuroStoxx 50 Index (Europe) and Nikkei 225 Index (Japan, Asia); most of that activity is based on the S&P 500 Index. Futures and options on the CBOE Volatility Index (VIX), based on S&P 500 index option prices, are by far the most active listed volatility contracts in the world. CBOE understands VIX-related activity currently represents the majority of all S&P 500-based volatility trading (listed and OTC).

CBOE understands that combination orders in SPX, including SPX Combo Orders, are also used as a way to trade volatility. By trading an SPX position “delta-neutral” with an offsetting combination in SPX, traders virtually eliminate market risk, leaving implied volatility as the predominant risk factor.

The Exchange is also proposing to revise the existing SPX Combo Order text to make certain clarifying amendments. In particular, the Exchange is proposing to revise the definition of an “SPX combination.” As noted above, currently an SPX combination is defined as “a long SPX call and a short SPX put having the same expiration date and strike price.” The Exchange is proposing to revise the definition to include a short SPX call and a long SPX put having the same expiration date and strike price. By definition, both strategies are permissible under the existing rule (otherwise one would never have a contra-side with which to trade; also, this clarification is consistent with other provisions of the rule that recognize both buy-side and sell-side interest). In addition, instead of using the terms “long” and “short,” the Exchange is proposing to use the terms “purchase” and “sale” to be consistent with the language in the existing definitions of “SPX Combo” and “delta” (which are noted above). Thus, as revised, an

“SPX combination” would be defined as “a purchase (sale) of an SPX call and a sale (purchase) of an SPX put having the same expiration date and strike price.” The Exchange is also proposing to revise the definition of an “SPX Combo” to replace the phrase “SPX options” with “an SPX option position” (as revised, the definition would be “an order to purchase or sell an SPX option position and the offsetting number of SPX combinations defined by the delta”). The use of the phrase “an SPX option position” is consistent with the language in the existing definition of delta (which is defined as “the positive (negative) number of SPX combinations that must be sold (bought) to establish a market neutral hedge with an SPX option position”) and also is intended to make it clear that an SPX Combo Order is intended to consist of an SPX combination (which has two component legs) that hedges an SPX option position (which can consist of one or more component legs). Finally, the Exchange is proposing to change a reference in the rule from “SPX combination” to the word “order.”<sup>14</sup> This change is intended to clarify the existing application of the rule. The use of the word “order” (which is intended to capture the broader SPX Combo order) is consistent with the terminology used elsewhere in the existing rule text<sup>15</sup> and with the Exchange’s general priority provisions for any complex order.<sup>16</sup>

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<sup>14</sup> The current text of Rule 24.2(b)(1) [sic] provide [sic] in relevant part as follows: “When a Trading Permit Holder holding an SPX Combo Order and bidding or offering in a multiple of the minimum increment on the basis of a total debit or credit for the order has determined that the order may not be executed by a combination of transactions with the bids and offers displayed in the SPX limit order book or by the displayed quotes of the crowd, then the order may be executed at the best net debit or credit so long as (A) no leg of the order would trade at a price outside the currently displayed bids or offers in the trading crowd or bids or offers in the SPX limit order book and (B) at least one leg of the SPX combination would trade at a price that is better than the corresponding bid or offer in the SPX limit order book.” (emphasis added). As proposed to be revised, the phrase “SPX combination” would be replaced with the word “order.”

<sup>15</sup> Id.

<sup>16</sup> See, e.g., Rules 6.45A(b) and 6.45B(b).

## 2. Statutory Basis

The Exchange believes that the proposed rule change will allow for the orderly execution of SPX Combo Orders and will be beneficial to both customers and traders. Accordingly, the Exchange believes the proposed rule change is consistent with and furthers the objectives of Section 6(b) of the Act,<sup>17</sup> in general, and Section 6(b)(5) of the Act,<sup>18</sup> in particular, in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest.

As noted above, the Exchange believes the proposed pilot procedure will facilitate the orderly execution of SPX Combo Orders at all times, including during volatile markets, in a manner that is more competitive with the existing CME process. In addition, the Exchange believes the proposed pilot procedure will continue to address customers' desire to show an order to other market participants to seek price improvement or additional liquidity. The Exchange also believes the proposed pilot procedure will continue to create an incentive for market-makers to reduce the price width of their markets because they know that their hedge price has been established and they will not have to trade in another market. Thus, customers who trade options tied to combinations will continue to enjoy tighter and more liquid markets

In proposing the pilot, CBOE is cognizant of the need for market participants to have substantial options transaction capacity and flexibility to hedge their trading activity in SPX, on the one hand, and priority principles common to securities exchanges, on the other. CBOE is also cognizant of the CME market, in which similar restrictions do not apply. In light of these

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<sup>17</sup> 15 U.S.C. 78f(b).

<sup>18</sup> 15 U.S.C. 78f(b)(5).

considerations, CBOE believes the proposed pilot procedure is appropriate and reasonable and would provide market participants with additional flexibility in achieving desired SPX Combo Order strategies and in determining whether to execute their options on CBOE or a comparable product on CME. In that regard, the Exchange notes that the proposed pilot procedure outlined above does not go as far as what exists today on CME and instead represents what the Exchange believe [sic] is only an incremental change to an existing trading process that is already very narrowly tailored. For the foregoing reasons, CBOE believes that the proposed new procedure for trading SPX Combo Orders is reasonable and appropriate, would promote just and equitable principles of trade, and would facilitate transactions in securities while continuing to foster the public interest and investor protection. Finally, the Exchange believes that the proposed revisions to the existing SPX Combo Order text will provide clarity on the existing application of the SPX Combo Order provisions.

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

The Exchange neither solicited nor received comments on the proposal.

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

Within 45 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 or disapprove 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 argument concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2012-122 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-2012-122. 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 website (<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 website viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also

will be available for inspection and copying at the principal offices 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-2012-122, 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.<sup>19</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).