

must be exposed on the System for at least 30 seconds before they may be executed by orders solicited from members and non-member broker-dealers. These rules ensure that the crossing procedures and the limitations on facilitation described above are not circumvented.

The CBOE*direct* rules also would prevent an SBT broker from being party to any arrangement designed to circumvent the proposed crossing rules by providing an opportunity for another party to execute against an agency order immediately after the broker had entered the order in the SBT System.²⁰⁰ The Commission believes that the prohibition on such arrangements is important, because an SBT broker and a third party could otherwise use CBOE*direct* to execute their orders with each other, without exposing these orders to other trading interest. The Commission believes that this prohibition should prove helpful in curbing a firm's ability to internalize order flow.²⁰¹

Finally, the proposed rules also include an interpretation stating that a violation of a member's duty of best execution would be presumed if the member were to cancel or withhold a facilitation order to avoid execution of the order at a better price.²⁰² Use of the crossing mechanism would not modify a member's best execution duty to its customer. The Commission believes that this interpretation is important to ensure that SBT brokers who propose to facilitate orders as principal fulfill their duty of best execution. In the Commission's view, withholding or withdrawing an order to be facilitated—that could benefit from price improvement available from other market participants—simply to avoid executing the order at the superior price would be a violation of the broker's best execution duty.²⁰³

As a national securities exchange, CBOE is required to enforce its members' compliance with their best execution obligations. The Commission notes that when a SBT broker enters a facilitation transaction into the crossing mechanism and then cancels the remainder of the customer order after the 40% of the order is executed, this could indicate—depending on the circumstances—that the broker originally overstated the size of the

customer order and, with the 40% execution, effectively internalized 100% of the customer order. This situation would not be consistent with the SBT system's crossing rules. CBOE has committed to surveil for instances when a SBT broker immediately cancels the crossing transaction once 40% of the order is executed. The Commission notes that if, after receiving the responses to an RFQ, the SBT broker elects not to enter the transaction into the crossing mechanism because he or she is unwilling to facilitate the customer order at the requisite price between the best bid and offer displayed by the System, depending on the circumstances, the SBT broker may have a best execution obligation to enter the customer order into the System to execute against the appropriate best response to the RFQ.

The Commission finds that the rules proposed by CBOE relating to crossing and internalization of orders on the SBT System are consistent with the Act. The Commission believes that these rules will promote intramarket price competition by providing SBT traders with a reasonable opportunity to compete for a significant percentage of the incoming order and, therefore, will protect investors and the public interest.

*F. Simultaneous Trading of the Same Security on CBOE*direct* and the Exchange Floor*

CBOE has not proposed any rules that would govern order handling and order priority if the same option were traded simultaneously on CBOE*direct* and on CBOE's floor-based market. Accordingly, the Commission is not approving the use of CBOE*direct* to trade any security during a trading session in which such security is trading on CBOE's floor-based market.²⁰⁴ The Commission believes that trading the same option classes on the floor and on the SBT System at the same time raises several issues under the Act that CBOE must address—by filing one or more proposed rule changes pursuant to section 19(b) of the Exchange Act²⁰⁵—before the Commission could approve concurrent trading of the same option classes.

G. Trade Nullification Procedures and the Firm Quote Rule

The rules governing CBOE*direct* provide for the ability of one or both parties to a transaction to nullify the trade. Both parties to the trade can agree

to have a trade nullified and, in that case, the CBOE*direct* rules prescribe that certain procedures be followed for negotiated trade nullification.

The rules also provide for a procedure whereby an SBT trader may request two trading officials to nullify a trade. Specifically, a trade may be nullified by one party to the transaction if a documented request is made within five minutes or, in the case of a public customer order, within 15 minutes of execution, and one of the following conditions is satisfied: (1) There is a verifiable disruption or malfunction in Exchange systems that cause a quote/order to trade in excess of its disseminated size or that prevent an SBT trader from updating or canceling its quote/order; (2) the trade resulted from an erroneous print in the underlying security that resulted in a trade higher or lower than the average trade in the underlying security by a specified factor; (3) the trade resulted from an erroneous quote in the primary market for the underlying when certain other conditions are met; or (4) the execution price of the trade is higher or lower than the theoretical price for the series by a specified factor. A party to the trade that disagrees with the trade nullification can appeal the determination under Chapter XIX of the Exchange's rules.

The Commission considers that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price or other terms of the executed trade are such that they are "clearly erroneous," suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, abrogating a trade should occur under specific and objective circumstances only. The trade nullification rule for CBOE*direct* contains specific and objective criteria with respect to the circumstances when a trade can be nullified, which helps to ensure that the rule would be applied in a fair and non-discriminatory manner. In addition, the conditions under which a trade can be nullified indicate that the error would be "clearly erroneous," *i.e.*, the terms of the trade clearly were outside of the norm for other trades that were executed within a proximate time frame. In addition, the CBOE*direct* rule on trade nullification contains clear procedures on how the trade would be nullified and provides a time frame within which a request to nullify a trade must be made. Finally, the trade nullification rule specifies the procedures to be followed for an appeal by a party who disagrees with the result.

²⁰⁰ See CBOE rule 43.12C(a).

²⁰¹ The Commission previously approved a similar provision as part of the ISE's rules. See ISE rule 400, Supplementary Material; ISE Order, 65 FR at 11400.

²⁰² See CBOE rule 43.12A, Interpretation .01.

²⁰³ See ISE Order, 65 FR at 11398 (discussing a similar provision in the ISE rules).

²⁰⁴ In Amendment No. 4, the Exchange eliminated the text of its proposed rule 43.10 regarding the trading of spread orders on CBOE*direct*.

²⁰⁵ 15 U.S.C. 78s(b).