

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52506; File No. SR-CBOE-2005-58)

September 23, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change Relating to the Exchange's Preferred Designated Primary Market-Maker Program

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 27, 2005, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. In addition, the Commission is granting accelerated approval of the proposed rule change.

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

The CBOE proposes to amend its rules governing its Preferred Designated Primary Market-Maker ("DPM") program to allow non-DPM Market-Makers to receive orders designated for a specific Market-Maker ("Preferred orders").³ Proposed new language is in italics; proposed deletions are in [brackets].

* * * * *

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ With the permission of the CBOE, the Commission made clarifications to the description of the proposed rule change as noted herein. Telephone conversation between David Hsu, Special Counsel, Theodore Venuti, Attorney, Division of Market Regulation, Commission, and Angelo Evangelou, Senior Managing Attorney, CBOE, on August 11, 2005.

Rule 8.13 Preferred Market-Maker Program

(a) Generally. The Exchange may allow, on a class-by-class basis, for the receipt of marketable orders, through the Exchange's Order Routing System when the Exchange's disseminated quote is the NBBO, that carry a designation from the member transmitting the order that specifies a Market-Maker in that class as the "Preferred Market-Maker" for that order. A qualifying recipient of a Preferred Market-Maker order shall be afforded a participation entitlement as set forth in subparagraph (c) below. The Preferred Market-Maker Program shall be in effect until June 2, 2006 on a pilot basis.

(b) Eligibility. Any Exchange Market-Maker type (e.g. Remote Market-Maker, Lead Market-Maker, and Designated Primary Market-Maker) may be designated as a Preferred Market-Maker, however, a recipient of a Preferred Market-Maker order will only receive a participation entitlement for such order if the following provisions are met:

(i) The Preferred Market-Maker must have an appointment/allocation in the relevant option class.

(ii) The Preferred Market-Maker must be quoting at the best bid/offer on the Exchange.

(iii) The Preferred Market-Maker must comply with the quoting obligations applicable to its Market-Maker type under Exchange rules and must provide continuous two-sided quotations in at least 90% of the series of each class for which it receives Preferred Market Maker orders.

(c) Entitlement Rate. Provided the provisions of subparagraph (b) above have been met, the Preferred Market-Maker participation entitlement shall be 40% when there are two or more Market-Makers also quoting at the best bid/offer on the Exchange, and 50% when there is only

one other Market-Maker quoting at the best bid/offer on the Exchange. In addition, the following shall apply:

(i) A Preferred Market-Maker may not be allocated a total quantity greater than the quantity that the Preferred Market-Maker is quoting at the best bid/offer on the Exchange.

(ii) The participation entitlement rate is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied.

(iii) If a Preferred Market-Maker receives a participation entitlement under this Rule, then no other participation entitlements set forth in Exchange Rules (e.g. Rule 8.87 Participation Entitlement of DPMs and e-DPMs and Rule 8.15B Participation Entitlement of LMMs) shall apply to such order.

* * * * *

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

Generally: The rules of priority and order allocation procedures set forth in this rule shall apply only to equity option classes designated by the Exchange to be traded on the CBOE Hybrid System and has no applicability to index option and options on ETF classes. The term "market participant" as used throughout this rule refers to a Market-Maker, an in-crowd DPM, an e-DPM, a Remote Market-Maker, and a floor broker representing orders in the trading crowd. The term "in-crowd market participant" only includes an in-crowd Market-Maker, in-crowd DPM, and floor broker representing orders in the trading crowd.

(a) Allocation of Incoming Electronic Orders: The Exchange shall apply, for each class of options, the following rules of trading priority.

(i) Ultimate Matching Algorithm ("UMA"): Under this method, a market participant who enters a quotation or order and whose quote or order is represented by the disseminated CBOE best bid or offer ("BBO") shall be eligible to receive allocations of incoming electronic orders for up to the size of its quote or order, in accordance with the principles described below. As an initial matter, if the number of contracts represented in the disseminated quote is less than the number of contracts in an incoming electronic order(s), the incoming electronic order(s) shall only be entitled to receive a number of contracts up to the size of the disseminated quote, in accordance with Rule 6.45A(a)(i)(B). The balance of the electronic order will be eligible to be filled at the refreshed quote either electronically (in accordance with paragraph (a)(i)(B) below) or manually (in accordance with Rule 6.45A(b)) and, as such, may receive a split price execution.

(A) Priority of Orders in the Electronic Book

(1) Public Customer Orders: Public customer orders in the electronic book have priority. Multiple public customer orders in the electronic book at the same price are ranked based on time priority. If a public customer order(s) in the electronic book matches, or is matched by, a market participant quote, the public customer order(s) shall have priority and, the balance of the incoming order, if any, will be allocated pursuant to Rule 6.45A(a)(i)(B).

(2) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate FPC determines to allow certain types of broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer orders in the electronic book at the best price shall be deemed one "market

participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "market participant" shall be distributed among each broker-dealer order comprising the "market participant" pursuant to Rule 6.45A(a)(i)(B).

(B) Allocation

(1) Market Participant Quoting Alone at BBO: When a market participant is quoting alone at the disseminated CBOE BBO and is not subsequently matched in the quote by other market participants prior to execution, it will be entitled to receive incoming electronic order(s) up to the size of its quote. If another market participant joins in the disseminated quote prior to execution of an incoming electronic order(s) such that more than one market participant is quoting at the BBO, incoming electronic order(s) will be distributed in accordance with (B)(2) below.

(2) More than One Market Participant Quoting at BBO: When more than one market participant is quoting at the BBO, inbound electronic orders shall be allocated pursuant to the following allocation algorithm:

$$\begin{array}{c}
 \text{Incoming} \\
 \text{Order Size}
 \end{array}
 \times
 \frac{
 \begin{array}{c}
 \text{Allocation Algorithm} \\
 \text{(Equal Percentage based} \\
 \text{on number of market} \\
 \text{participants quoting at BBO)} \\
 \text{(Component A)}
 \end{array}
 +
 \begin{array}{c}
 \text{(Pro-rata Percentage} \\
 \text{based on size of market} \\
 \text{participant quotes)} \\
 \text{(Component B)}
 \end{array}
 }{2}$$

Where:

Component A: The percentage to be used for Component A shall be an equal percentage, derived by dividing 100 by the number of market participants quoting at the BBO.

Component B: Size Prorata Allocation. The percentage to be used for Component B of the Allocation Algorithm formula is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote.

Final Weighting: The final weighting formula for equity options, which shall be determined by the appropriate FPC and apply uniformly across all options under its jurisdiction, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Initially, the weighting of components A and B shall be equal, represented mathematically by the formula:

$$((\text{Component A Percentage} + \text{Component B Percentage})/2) * \text{incoming order size.}$$

(C) [DPM] Participation Entitlement: If a [DPM or e-DPM] Market-Maker is eligible for an allocation pursuant to the operation of the Algorithm described in paragraph (a) of Rule 6.45A and is also eligible for an allocation pursuant to a participation entitlement under Rules 8.13, 8.15B, or 8.87, the Market-Maker [DPM or e-DPM] shall be entitled to receive an allocation (not to exceed the size of its [the DPM's or e-DPM's] quote) equal to either:

(1) the greater of the amount the Market-Maker [it] would be entitled to pursuant to the participation entitlement [right established pursuant to Rule 8.87 (and Regulatory Circulars issued thereunder)] or the amount it would otherwise receive pursuant to the operation of the Algorithm described above provided, however, that in calculating a [the] DPM's allocation under the Algorithm, DPMs utilizing more than one membership in the trading crowd where the subject class is traded shall count as two market participants for purposes of Component A of the Algorithm; or

(2) the amount the Market-Maker [it] would be entitled to pursuant to the participation entitlement. [right established pursuant to Rule 8.87 (and Regulatory Circulars issued thereunder).]

The appropriate FPC shall determine which of the preceding two entitlement formulas will be in effect for all classes under its jurisdiction. All pronouncements regarding the entitlement formula shall be made via Regulatory Circular. The participation entitlement percentage is expressed as a percentage of the remaining quantity after all public customer orders in the electronic book have been executed.

(b)-(e) No change.

... Interpretations and Policies:

.01 - .02. No change.

* * * * *

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

Generally: The rules of priority and order allocation procedures set forth in this rule shall apply only to index options and options on ETFs that have been designated for trading on the CBOE Hybrid System. The term "market participant" as used throughout this rule refers to a Market-Maker, a Remote Market-Maker, an in-crowd DPM or LMM, an e-DPM with an appointment in the subject class, and a floor broker representing orders in the trading crowd. The term "in-crowd market participant" only includes an in-crowd Market-Maker, in-crowd DPM or LMM, and floor broker representing orders in the trading crowd.

(a) Allocation of Incoming Electronic Orders: The appropriate Exchange procedures committee 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 appropriate Exchange committee changes the priority.

(i) Price-Time or Pro-Rata Priority

Price-Time Priority: Under this method, resting quotes and orders in the book are prioritized according to price and time. If there are two or more quotes or orders at the best price then priority is afforded among these quotes or orders in the order in which they were received by the Hybrid System; or

Pro-Rata Priority: Under this method, resting quotes and orders in the book are prioritized according to price. If there are two or more quotes or orders at the best price then trades are allocated proportionally according to size (in a pro-rata fashion). The executable quantity is allocated to the nearest whole number, with fractions $1/2$ or greater rounded up and fractions less than $1/2$ rounded down. If there are two market participants that both are entitled to an additional $1/2$ contract and there is only one contract remaining to be distributed, the additional contract will be distributed to the market participant whose quote or order has time priority.

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

Methods

In addition to the base allocation methodologies set forth above, the appropriate Exchange procedures committee may determine to apply, on a class-by-class basis, either or both of the following designated market participant overlay priorities. 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 appropriate Exchange procedures committee changes these priorities.

(1) Public Customer: When this priority overlay is in effect, the highest bid and lowest offer shall have priority except that public customer orders shall have priority over non-public customer orders at the same price. If there are two or more public customer orders for the same options series at the same price, priority shall be afforded to such public customer orders in the sequence in which they are received by the System, even if the Pro-Rata Priority allocation method is the chosen allocation method. For purposes of this Rule, a Public Customer order is an order for an account in which no member, non-member participant in a joint-venture with a member, or non-member broker-dealer (including a foreign broker-dealer) has an interest.

(2) Participation Entitlement: The appropriate Exchange procedures committee may determine to grant Market-Makers [DPMs, LMMs, or e-DPMs] participation entitlements pursuant to the provisions of Rule 8.87, Rule 8.13, or 8.15B. In allocating the participation entitlement, all of the following shall apply:

(A) To be entitled to their participation entitlement, the Market-Maker's [a DPM's or LMM's or e-DPM's] order and/or quote must be at the best price on the Exchange.

(B) The Market-Maker [A DPM or LMM or e-DPM] may not be allocated a total quantity greater than the quantity that it [the DPM or LMM or e-DPM] is quoting (including orders not part of quotes) at that price. If Pro-Rata Priority is in effect, and the Market-Maker's [DPM's or LMM's or e-DPM'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 [DPM or LMM or e-DPM] shall not receive any further allocation of that order.

(C) In establishing the counterparties to a particular trade, the [DPM's or LMM's or e-DPM's] participation entitlement must first be counted against that Market-Maker's [the DPM's or LMM's or e-DPM's] highest priority bids or offers.

(D) 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.

(ii) Ultimate Matching Algorithm ("UMA"): Under this method, a market participant who enters a quotation and whose quote is represented by the disseminated CBOE best bid or offer ("BBO") shall be eligible to receive allocations of incoming electronic orders for up to the size of its quote, in accordance with the principles described below. As an initial matter, if the number of contracts represented in the disseminated quote is less than the number of contracts in an incoming electronic order(s), the incoming electronic order(s) shall only be entitled to receive a number of contracts up to the size of the disseminated quote, in accordance with Rule 6.45B(a)(ii)(B). The balance of the electronic order will be eligible to be filled at the refreshed quote either electronically (in accordance with paragraph (a)(ii)(B) below) or manually (in accordance with Rule 6.45B(b)) and, as such, may receive a split price execution.

(A) Priority of Orders in the Electronic Book

(1) Public Customer Orders: Public customer orders in the electronic book have priority. Multiple public customer orders in the electronic book at the same price

are ranked based on time priority. If a public customer order(s) in the electronic book matches, or is matched by, a market participant quote, the public customer order(s) shall have priority and, the balance of the incoming order, if any, will be allocated pursuant to Rule 6.45B(a)(ii).

(2) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate Exchange procedures committee determines to allow certain types of broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer orders in the electronic book at the best price shall be deemed one "market participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "market participant" shall be distributed among each broker-dealer order comprising the "market participant" pursuant to Rule 6.45B(a)(ii)(B).

(B) Allocation

(1) Market Participant Quoting Alone at BBO: When a market participant is quoting alone at the disseminated CBOE BBO and is not subsequently matched in the quote by other market participants prior to execution, it will be entitled to receive incoming electronic order(s) up to the size of its quote. If another market participant joins in the disseminated quote prior to execution of an incoming electronic order(s) such that more than one market participant is quoting at the BBO, incoming electronic order(s) will be distributed in accordance with (B)(2) below.

(2) More than One Market Participant Quoting at BBO: When more than one market participant is quoting at the BBO, inbound electronic orders shall be allocated pursuant to the following allocation algorithm:

$$\text{Incoming Order Size} \times \frac{\text{Allocation Algorithm}}{2}$$

$$\left(\begin{array}{l} \text{(Equal Percentage based} \\ \text{on number of market} \\ \text{participants quoting at BBO)} \\ \text{(Component A)} \end{array} + \begin{array}{l} \text{(Pro-rata Percentage} \\ \text{based on size of market} \\ \text{participant quotes)} \\ \text{(Component B)} \end{array} \right)$$

Where:

Component A: The percentage to be used for Component A shall be an equal percentage, derived by dividing 100 by the number of market participants quoting at the BBO.

Component B: Size Pro-rata Allocation. The percentage to be used for Component B of the Allocation Algorithm formula is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote.

Final Weighting: The final weighting formula, which shall be established by the appropriate Exchange procedures committee and may vary by product, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.

(C) Participation Entitlement: If a Market-Maker [DPM, LMM, or e-DPM] is eligible for an allocation pursuant to the operation of the Algorithm described in paragraph (a) of Rule 6.45B and is also eligible for an allocation pursuant to a

participation entitlement under Rules 8.13, 8.15B, or 8.87, the Market-Maker [DPM, LMM, or e-DPM] may be entitled to receive an allocation (not to exceed the size of its quote) equal to either:

- (1) the greater of the amount it would be entitled to pursuant to the participation entitlement [right established pursuant to Rule 8.87 or 8.15B (and Regulatory Circulars issued thereunder)] or the amount it would otherwise receive pursuant to the operation of the Algorithm described above provided, however, that in calculating a [the] DPM's or LMM's allocation under the Algorithm, DPMs or LMMs utilizing more than one membership in the trading crowd where the subject class is traded shall count as two market participants for purposes of Component A of the Algorithm; or
- (2) the amount it would be entitled to pursuant to the participation entitlement [right established pursuant to Rule 8.87 or 8.15B (and Regulatory Circulars issued thereunder)]; or
- (3) The amount it would be entitled to receive pursuant to the operation of the Algorithm described above provided, however, that in calculating a [the] DPM's or LMM's allocation under the Algorithm, DPMs or LMMs utilizing more than one membership in the trading crowd where the subject class is traded shall count as two market participants for purposes of Component A of the Algorithm.

The appropriate Exchange procedures committee shall determine which of the preceding three entitlement formulas will be in effect on a class-by-class basis. All pronouncements regarding the entitlement formula shall be made via Regulatory Circular. The participation entitlement percentage is expressed as a percentage of the

remaining quantity after all public customer orders in the electronic book have been executed.

(b)-(d) No change.

. . . Interpretations and Policies:

.01- .02. No change.

* * * * *

Rule 8.15B Participation Entitlement of LMMs

(a) The appropriate Market Performance Committee may establish, on a class-by-class basis, a participation entitlement formula that is applicable to LMMs.

(b) To be entitled to a participation entitlement, the LMM must be quoting at the best bid/offer on the Exchange and the LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange. The participation entitlement is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied. The participation entitlement set forth in this Rule shall not apply in instances where a Preferred Market-Maker receives a participation entitlement pursuant to Rule 8.13.

(c) The LMM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange; and, 30% when there are three or more Market-Makers also quoting at the best bid/offer on the Exchange. If more than one LMM is entitled to a participation entitlement, such entitlement shall be distributed equally among all eligible LMMs provided, however, that an LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange.

The appropriate Market Performance Committee may determine, on a class-by-class basis, to decrease the LMM participation entitlement percentages from the percentages specified in paragraph (c). Such changes will be announced to the membership in advance of implementation via Regulatory Circular.

* * * * *

Rule 8.87. Participation Entitlement of DPMs and e-DPMs

(a) Subject to the review of the Board of Directors, the MTS Committee may establish from time to time a participation entitlement formula that is applicable to all DPMs.

(b) The participation entitlement for DPMs and e-DPMs (as defined in Rule 8.92) shall operate as follows:

(1) Generally.

(i) To be entitled to a participation entitlement, the DPM/e-DPM must be quoting at the best bid/offer on the Exchange.

(ii) A DPM/e-DPM may not be allocated a total quantity greater than the quantity that the DPM/e-DPM is quoting at the best bid/offer on the Exchange.

(iii) The participation entitlement is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied.

(2) Participation Rates applicable to DPM Complex. The collective DPM/e-DPM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange; and, 30% when there are three or more Market-Makers also quoting at the best bid/offer on the Exchange.

(3) Allocation of Participation Entitlement Between DPMs and e-DPMs. The participation entitlement shall be as follows: If the DPM and one or more e-DPMs are quoting at the best bid/offer on the Exchange, the e-DPM participation entitlement shall be one-half (50%) of the total DPM/e-DPM entitlement and shall be divided equally by the number of e-DPMs quoting at the best bid/offer on the Exchange. The remaining half shall be allocated to the DPM. If the DPM is not quoting at the best bid/offer on the Exchange and one or more e-DPMs are quoting at the best bid/offer on the Exchange, then the e-DPMs shall be allocated the entire participation entitlement (divided equally between them). If no e-DPMs are quoting at the best bid/offer on the Exchange and the DPM is quoting at the best bid/offer on the Exchange, then the DPM shall be allocated the entire participation entitlement. If only the DPM and/or e-DPMs are quoting at the best bid/offer on the Exchange (with no Market-Makers at that price), the participation entitlement shall not be applicable and the allocation procedures under Rule 6.45A shall apply.

(4) [Allocation of] Participation Entitlement In Instances Where a Preferred Market-Maker Receives a Participation Entitlement Pursuant to Rule 8.13.

The participation entitlement set forth in this Rule shall not apply in instances where a Preferred Market-Maker receives a participation entitlement pursuant to Rule 8.13.

[Between DPMs and e-DPMs for Orders Specifying a Preferred DPM. Notwithstanding the provisions of subparagraph (b)(3) above, the Exchange may allow, on a class-by-class basis, for the receipt of marketable orders, through the Exchange's Order Routing System when the Exchange's disseminated quote is the NBBO, that carry a designation from the

member transmitting the order that specifies a DPM or e-DPM in that class as the "Preferred DPM" for that order.

In such cases and after the provisions of subparagraph (b)(1)(i) and (iii) above have been met, then the Preferred DPM participation entitlement shall be 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; and 40% when there are two or more Market-Makers also quoting at the best bid/offer on the Exchange, subject to the following:

- (i) if the Preferred DPM is not quoting at the best bid/offer on the Exchange then the participation entitlement set forth in subparagraph (b)(3) above shall apply;
- (ii) in no case shall the Preferred DPM be allocated, pursuant to this participation right, a total quantity greater than the quantity that the Preferred DPM is quoting at the best bid/offer on the Exchange.

The Preferred DPM participation entitlement set forth in subparagraph (b)(4) of this Rule shall be in effect until June 2, 2006 on a pilot basis.]

... Interpretations and Policies:

.01 No change.

* * * * *

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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it had received on the proposed rule change. The text of these statements may be examined at the places

specified in Item III below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

CBOE Rule 8.87 governs the application of the Exchange's recently approved Preferred DPM Program.⁴ Under the program, order providers can send an order to the Exchange designating a "Preferred DPM" from among the DPM Complex.⁵ If the Preferred DPM is quoting at the national best bid or offer ("NBBO") at the time the order is received on CBOE, the Preferred DPM, after public customer orders at the best bid/offer on the Exchange are filled, is entitled to a 40% allocation of the order when there are two or more Market-Makers also quoting at the best bid/offer on the Exchange, and 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange.⁶

The Philadelphia Stock Exchange ("Phlx") recently obtained approval of a Directed Order Program that allows a recipient of a directed order on the Phlx to receive a 40%

⁴ Securities Exchange Act Release No. 51779 (June 2, 2005), 70 FR 33564 (June 8, 2005) (order approving File No. SR-CBOE-2004-71). A modification to the applicable participation entitlement percentages under the program was also recently effected. See Securities Exchange Act Release No. 51824 (June 10, 2005), 70 FR 35476 (June 20, 2005) (notice of filing and immediate effectiveness of File No. SR-CBOE-2005-45). See also Securities Exchange Act Release No. 52021 (July 13, 2005), 70 FR 41462 (July 19, 2005) (notice of filing and order granting accelerated approval to File No. SR-CBOE-2005-50).

⁵ The DPM Complex consists of the DPM and electronic DPMs in the class. See supra note 3.

⁶ Id.

participation entitlement on designated orders received while that entity is quoting at the NBBO.⁷ The International Securities Exchange (“ISE”) also recently obtained approval to implement a preferencing program that allows a preferenced ISE market maker to receive a 40% participation entitlement on designated orders received while that market maker is quoting at the NBBO.⁸ Unlike CBOE’s program, these exchanges allow any non-specialist market maker to receive “preferred” orders, provided such market maker is fulfilling certain heightened quoting obligations. The purpose of this filing is to expand CBOE’s Preferred DPM Program to allow any CBOE Market-Maker to receive Preferred orders.

The Exchange proposes to accomplish this by renaming the program the “Preferred Market-Maker Program” and creating new CBOE Rule 8.13 to govern the program. That rule is virtually identical to the portion of CBOE Rule 8.87 that pertains to the Preferred DPM Program (which would be deleted), except that the new rule (i) would expand the program to non-DPM Market-Makers (including Remote Market-Makers and Lead Market-Makers), (ii) would provide that a Market-Maker would be required to have an appointment in a class in order to receive Preferred orders in that class, (iii) would provide that, to receive a Preferred order, a Market-Maker would be required to provide continuous two-sided quotations in at least 90% of the series of each class for which it receives Preferred Market Maker orders; and (iv) would provide that, if a participation entitlement is provided under CBOE Rule 8.13, no other participation entitlement under any other rule would apply. Provisions also would be added to the rules establishing participation entitlements for DPMs and LMMs (CBOE Rule 8.87 and CBOE Rule 8.15B) to

⁷ Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (order approving File No. SR-Phlx-2004-91).

⁸ Securities Exchange Act Release No. 51818 (June 10, 2005), 70 FR 35146 (June 16, 2005) (order approving File No. SR-ISE-2005-18).

expressly provide that participation entitlements under those rules would not apply in instances where a participation entitlement is granted pursuant to new CBOE Rule 8.13. Lastly, changes are proposed to CBOE's Hybrid order allocation rules (CBOE Rule 6.45A for equity options and CBOE Rule 6.45B for index options) to provide that Market-Makers receiving a Preferred participation entitlement pursuant to CBOE Rule 8.13 may be allocated the greater of such entitlement or the quantity that the Market-Maker would receive under the applicable matching algorithm of the order allocation rule in effect. The matching algorithm rules already contain such language for DPMs; the language now would merely be expanded to include any Preferred Market-Maker.

The Exchange notes that the Preferred DPM program is operating as a one-year pilot program.

2. Statutory Basis

The CBOE believes the proposed rule change is consistent with Section 6(b) of the Act,⁹ in general, and furthers the objectives of Section 6(b)(5),¹⁰ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

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

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

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. 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-2005-58 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2005-58. 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 Section, 100 F

Street, NE, Washington, DC 20549. 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 publicly available. All submissions should refer to File Number SR-CBOE-2005-58 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder, applicable to a national securities exchange.¹¹ In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹² which requires among other things, that the rules of the Exchange are designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission notes that the Preferred DPM Program currently operates on a pilot basis.¹³ The proposal would expand the Preferred DPM Program to allow any non-DPM Market-Maker to receive Preferred orders in a class. The Commission notes that a non-DPM Market-Maker: (i) must have an appointment in a class; (ii) must provide continuous two-sided quotations in at least 90% of the series of that class; and (iii) must be quoting at the best bid/offer on the Exchange (which would

¹¹ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78f(b)(5).

¹³ See supra note 4.

be the NBBO) in order to receive a participation entitlement in that class under the Preferred Market-Maker Program. In addition, the Commission notes that it has approved similar preferencing programs on other options exchanges.¹⁴ Furthermore, the Commission notes that the Exchange represented that it will proactively conduct surveillance for, and enforce against, coordinated actions between a Market-Maker and an order entry firm.¹⁵

The CBOE has requested that the Commission find good cause for approving the proposed rule change prior to the thirtieth day after publication of notice thereof in the Federal Register. The Commission believes that granting accelerated approval of the proposal should allow the CBOE to immediately implement its Preferred Market-Maker Program. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹⁶ for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

¹⁴ See supra notes 7 and 8.

¹⁵ See letter from Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, to John Roeser, Assistant Director, Division of Market Regulation, Commission, dated September 19, 2005.

¹⁶ 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (SR-CBOE-2005-58) be, and hereby is, approved on an accelerated basis, for a pilot period to expire on June 2, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Jonathan G. Katz
Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).