

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54395; File No. SR-CBOE-2006-58)

August 31, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change and Amendment No. 1 Thereto Regarding DPM and e-DPM Membership Ownership Requirements and the Ultimate Matching Algorithm

I. Introduction

On June 14, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposal to change membership ownership requirements. The CBOE filed Amendment No. 1 to the proposed rule change on July 18, 2006,³ which proposed to change certain aspects of the Ultimate Matching Algorithm (“UMA”). The proposed rule change was published for comment in the Federal Register on August 1, 2006.⁴ The Commission received no comments on the proposal, as amended. This order approves the proposed rule change, as amended.

II. Description of the Proposal

CBOE Rules 8.85 and 8.92 require that a DPM organization and e-DPM organization, respectively, own a certain number of Exchange memberships. Specifically, with respect to DPM organizations, CBOE Rule 8.85 requires that each DPM organization own one

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superseded the original filing in its entirety.

⁴ See Securities Exchange Act Release No. 54216 (July 26, 2006), 71 FR 35471.

Exchange membership for each trading location at which the organization serves as a DPM. CBOE Rule 8.92 requires that until July 12, 2007, each e-DPM organization is required to own one Exchange membership for every 30 products allocated to the e-DPM, or lease one Exchange membership for every 20 products allocated to the e-DPM.⁵

CBOE proposes to modify these membership ownership requirements in connection with the Exchange's determination to apply a specific "appointment cost" to each options class allocated to a DPM organization or an e-DPM organization. With respect to DPM organizations, CBOE Rule 8.85, as proposed to be amended, would require that each DPM organization own one Exchange membership, and own or lease such additional Exchange memberships as may be necessary based on the aggregate "appointment cost" for the classes allocated to the DPM organization. Each membership owned or leased by the DPM organization would have an appointment credit of 1.0. The appointment costs for the Hybrid 2.0 Option Classes and the Non-Hybrid Classes allocated to the DPM organization would be the same as the appointment costs set forth in CBOE Rule 8.3. The appointment cost for Hybrid Option Classes would be .01 per class.

For example, if the DPM organization has been allocated such number of options classes that its aggregate appointment cost is 1.6, the DPM organization would be required to own at least one Exchange membership, and own or lease one additional Exchange membership. As it currently does for purposes of Remote Market Maker ("RMMs") and Market-Maker appointments, the Exchange would rebalance the "tiers" set forth in proposed CBOE Rule 8.3(c)(i), excluding the "AA" and "A+" tiers, once each calendar quarter, which could result in additions or deletions to their composition. When a class changes "tiers" it

⁵ After July 12, 2007, each e-DPM organization is required to own one Exchange membership for every 30 products allocated to the e-DPM.

would be assigned the “appointment cost” of that tier. Upon rebalancing, each DPM organization would be required to own or lease the appropriate number of Exchange memberships reflecting the revised “appointment costs” of the classes that have been allocated to it. CBOE Rule 8.85 also would provide that a DPM organization is required to own or lease the appropriate number of Exchange memberships at the time a new options class allocated to it pursuant to CBOE Rule 8.95 begins trading.

Additionally, because member organizations may be approved and function in a number of capacities at CBOE, including as a DPM organization, e-DPM organization, and as an RMM, CBOE proposes to allow the DPM organization to use any excess membership capacity in its capacity as an RMM or e-DPM. Specifically, in the event the member organization approved as the DPM organization is also approved to act as an RMM and/or e-DPM, and has excess membership capacity above the aggregate appointment cost for the classes allocated to it as the DPM, the member organization would be permitted to utilize the excess membership capacity to quote electronically in an appropriate number of Hybrid 2.0 Classes in the capacity of an RMM and not trade in open outcry, or to quote electronically in the Hybrid 2.0 Classes in which it is appointed an e-DPM. For example, if the DPM organization has been allocated such number of option classes that its aggregate appointment cost is 1.6, the member organization could request an appointment as an RMM in any combination of Hybrid 2.0 Classes whose aggregate “appointment cost” does not exceed .40. The member organization would not function as a DPM in any of these additional classes. In the event the member organization utilizes any excess membership capacity to quote electronically in some additional Hybrid 2.0 Classes as an RMM or e-DPM, it would be required to comply with the provisions of CBOE Rules 8.4(c) and Rule 8.93(vii),

respectively. CBOE is also proposing similar changes to CBOE Rule 8.92, to apply to e-DPM organizations.

Finally, CBOE proposes to amend the provisions of CBOE Rules 6.45A for DPMs and 6.45B for DPMs and LMMs, which provide that a DPM or LMM utilizing more than one membership in the trading crowd where a class is traded would count as two market participants for purposes of Component A of UMA. Under the proposal, a DPM (or LMM) would be required to exclusively use the portion of a membership(s) representing one-half the total appointment cost of the classes allocated to the DPM (or, in which the LMM has been appointed) at a particular trading station in order to count as two market participants, and not for any other purpose.

For example, if a DPM's appointment cost is 2.2 for the classes allocated to it at a particular trading station, pursuant to proposed amendments to CBOE Rule 8.85(e), the DPM would be required to own one membership and own or lease two additional memberships. In addition, the DPM would be permitted to choose to count as two market participants for purposes of Component A of the Algorithm if the DPM exclusively utilizes 1.1 (one-half of 2.2) of the membership(s) it owns or leases in order to count as two market participants, and not utilize the 1.1 of the memberships for any other purpose. In this example, to comply with the membership ownership requirements and to count as two market participants for purposes of Component A, the DPM would be required to own one membership, and own or lease three additional memberships to satisfy its total cost of 3.3 (2.2 + 1.1).

In amending CBOE Rules 6.45A and 6.45B, CBOE proposes to make it optional for a DPM (or LMM) to choose whether to exclusively use the portion of its membership(s) representing one-half the total appointment cost of the classes allocated to the DPM at a

particular trading station in order to count as two market participants, or, instead, to use the excess membership capacity to quote electronically in Hybrid 2.0 Classes.

III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of Section 6 of the Act⁶ and the rules and regulations thereunder.⁷ The Commission specifically finds that the proposed rule change is consistent with Section 6(b)(5) of the Act⁸ in that it is designed to promote just and equitable principles of trade, to remove impediments and to 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 believes that the proposal to apply the appointment cost structure that currently governs RMMs and Market Makers to DPMs and e-DPMs is reasonable. The Commission notes that there will continue to be a DPM allocated to each equity options class. Moreover, permitting DPMs and e-DPMs to use any excess membership capacity to trade options classes as RMM or DPM/e-DPM should enable them to more efficiently use their seats. Finally, the Commission believes that in light of the proposed changes to the appointment cost structure, the proposed changes to UMA, and the circumstances under which a DPM or LMM may count as two market participants, are consistent with the Act.

⁶ 15 U.S.C. 78f.

⁷ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁹ that the proposed rule change (SR-CBOE-2006-58), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Nancy M. Morris
Secretary

⁹ 15 U.S.C. 78s(b)(2).

¹⁰ 17 CFR 200.30-3(a)(12).