

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49577; File No. SR-CBOE-2004-17)

April 19, 2004

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Establishing a Process for Approving and Appointing Remote Electronic Designated Primary Market-Makers

I. Introduction

On March 11, 2004, 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 proposed rule change to adopt new rules establishing a process for approving and appointing remote electronic Designated Primary Market-Makers (“e-DPMs”). On March 11, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.³ On March 18, 2004, the CBOE’s rule proposal, as amended, was published for comment in the Federal Register.⁴ No comment letters were received on the proposal. This order approves the proposal and Amendment No. 1 thereto.

II. Description of Proposal

The CBOE is currently in the process of proposing significant enhancements to its Hybrid Trading System (“CBOE Hybrid 2.0 initiatives”) including, among other things, the addition of a proposed new category of CBOE market-making participants called e-DPMs. e-DPMs would be member organizations appointed to operate on CBOE as competing Designated

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superceded the CBOE’s original 19b-4 filing in its entirety.

⁴ See Securities Exchange Act Release No. 49411 (March 12, 2004), 69 FR 12878.

Primary Market-Makers (“DPMs”) in a broad number of option classes. The purpose of this filing is to establish rules and criteria to allow the CBOE to begin approving and appointing e-DPMs. In its filing, the CBOE acknowledges that any such e-DPM appointments would be contingent on Commission approval of e-DPMs and CBOE rules governing e-DPM trading procedures and obligations, which the CBOE has not yet submitted to the Commission, but plans to do so soon as a separate rule filing.

The CBOE expects to approve and appoint a limited number of e-DPMs. The Exchange’s Board of Directors has established a special appointments committee, consisting of the Lessor Director, two Public Directors, the Vice Chairman, and the President, to select the firms that would be designated as e-DPMs, and to make initial e-DPM option class allocations. Candidates seeking appointment as an e-DPM would be evaluated on the basis of how well they meet the following criteria:

- Significant market-making and/or specialist experience in a broad array of securities;
- Superior resources, including capital, technology and personnel;
- Demonstrated history of stability, superior electronic capacity, and superior operational capacity;
- Proven ability to interact with order flow in all types of markets;
- Existence of order flow commitments;
- Willingness to accept allocations as an e-DPM in options overlying 400 or more securities; and
- Willingness and ability to make competitive markets on CBOE and otherwise to promote CBOE in a manner that is likely to enhance the ability of CBOE to compete successfully for order flow in the options it trades.

The CBOE represents that it intends to use the final factor listed to take into consideration in the selection process which of the applicants would best be able to enhance the competitiveness of the Exchange. “Willingness to promote CBOE” includes assisting in meeting and educating market participants, maintaining communications with member firms in order to be responsive to suggestions and complaints, responding to suggestions and complaints, and other like activities. Further, the CBOE would not apply this factor to in any way restrict, either directly or indirectly, e-DPMs’ activities as market makers or specialists elsewhere, or to restrict how e-DPMs handle orders held by them in a fiduciary capacity to which they owe a duty of best execution.

The CBOE represents that it would use the factor relating to the existence of order flow commitments to evaluate existing order flow commitments between the applicant and order flow providers. A future change to, or termination of, any such commitments considered by the Exchange during the review process would not be used by the Exchange at any point in the future to terminate or take remedial action against an e-DPM. Furthermore, the Exchange would not take remedial action solely because orders subject to any such commitments were not subsequently routed to the Exchange. Whether actual commitments result in orders being routed to the Exchange would be considered by the Exchange as a separate matter from the criteria for which an e-DPM’s performance would be evaluated.

As part of the approval of an e-DPM, the Exchange may place conditions on the approval based on the operations of the applicant and the number of option classes that may be allocated to the applicant. Moreover, each e-DPM shall retain its approval to operate as an e-DPM unless such approval is removed by the Exchange pursuant to appropriate rules. Finally, an e-DPM may not transfer its approval to act as an e-DPM unless allowed by the Exchange.

III. Discussion

After careful review, 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 exchange⁵ and, in particular, the requirements of Section 6 of the Act.⁶ Specifically, the Commission finds that the proposal to approve and appoint e-DPMs and to make initial e-DPM option class allocations is consistent with Section 6(b)(5) of the Act,⁷ in that the proposal has been designed to promote just and equitable principles of trade, and to protect investors and the public interest.

The Commission notes that the CBOE's proposed criteria for making e-DPMs selections is similar to the appointment and allocation criteria that is used by other exchanges that have competing specialists⁸ and similar to CBOE Rule 8.83, which governs selection criteria for DPMs. The Commission believes that the proposed criteria should be used by the CBOE solely for the purpose of evaluating applicants for e-DPM appointments and for making any option class allocations to them. The Commission emphasizes that the CBOE should not use the proposed criteria – especially the “willingness and ability to make competitive markets on CBOE and otherwise to promote CBOE” criterion – to in any way directly or indirectly attempt to restrict a market participant that is appointed as an e-DPM from performing market-making or specialist activities on other markets. In addition, with regard to the “order flow commitment” criterion, the Commission believes that the CBOE should consider only any existing order flow

⁵ The Commission has considered the proposed rule change's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

⁶ 15 U.S.C. 78f.

⁷ 15 U.S.C. 78f(b)(5).

⁸ See, e.g., Boston Stock Exchange Rule 18 and Philadelphia Stock Exchange Rule 511.

commitments that the applicant has with order flow providers, and that the CBOE should not use those existing order flow commitments as an indicator of potential future order flow that an applicant may be able to bring to the CBOE.

The Commission notes that all approvals and appointments of e-DPMs and allocations of options classes to such e-DPMs under this proposal are contingent on Commission approval of e-DPMs and CBOE rules governing e-DPM trading procedures and obligations. Moreover, in approving the e-DPM appointment criteria, the Commission is not prejudging the CBOE's prospective proposals relating to e-DPMs and other CBOE Hybrid 2.0 initiatives. If the Commission were not to approve e-DPMs, any e-DPM appointments made pursuant to this proposal would be meaningless. Approving the e-DPM appointment criteria does, however, afford the CBOE an opportunity to prepare for the possibility that the Commission will approve e-DPMs and CBOE rules governing e-DPM trading procedures and obligations, and reduces the time between any such approval and the commencement of trading by e-DPMs pursuant to the Exchange's proposed CBOE Hybrid 2.0 initiatives.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁹ that the proposed rule change (File No. SR-CBOE-2004-17) and Amendment No. 1 are hereby approved.

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

Margaret H. McFarland
Deputy Secretary

⁹ 15 U.S.C. 78s(b)(2).

¹⁰ 17 CFR 200.30-3(a)(12).