

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49990; File No. SR-CBOE-2003-39)

July 8, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, and 3 Thereto by the Chicago Board Options Exchange, Inc. Relating to Quote Sizes

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4² thereunder, notice is hereby given that on September 12, 2003, the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On October 29, 2003, the CBOE filed Amendment No. 1 to the proposed rule change.³ On June 10, 2004, the CBOE filed Amendment No. 2 to the proposed rule change.⁴ On June 28, 2004, the CBOE filed Amendment No. 3 to the proposed rule change.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Steve Youhn, Senior Attorney, CBOE, to Deborah Flynn, Assistant Director, Division of Market Regulation (“Division”), Commission, dated October 28, 2003 (“Amendment No. 1”).

⁴ See letter from Steve Youhn, Senior Attorney, CBOE, to Nancy Sanow, Assistant Director, Division, Commission, dated June 9, 2003 (“Amendment No. 2”). In Amendment No. 2, CBOE replaced the original rule filing in its entirety.

⁵ See letter from Steve Youhn, Senior Attorney, CBOE, to Nancy Sanow, Assistant Director, Division, Commission, dated June 25, 2003 (“Amendment No. 3”). In Amendment No. 3, CBOE made technical corrections to the proposed rule text.

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

The Exchange proposes to amend its rules relating to options market maker quote size requirements. Below is the text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in [brackets].

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Rule 8.7 Obligations of Market Makers

(a) – (c) No change

(d) Market Making Obligations Applicable in Hybrid Classes

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(i) Market Maker Trades Less Than 20% Contract Volume Electronically.

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(A) No Change

(B) Continuous Electronic Quoting Obligation: The Market-Maker will not be obligated to quote electronically in any designated percentage of series within that class. If a market maker quotes electronically, its undecremented quote must be for at least ten contracts[.] (“10-up”), unless the underlying primary market disseminates a 100-share quote, in which case the Market-Maker’s undecremented quote may be for as low as 1-contract (“1-up”). The ability to quote 1-up when the underlying primary quotes 100 shares is expressly conditioned on the process being automated (i.e., a Market-Maker may not manually adjust his quotes to reflect 1-up sizes). Quotes must automatically return to at least 10-up when the underlying primary market no longer disseminates a 100-share quote. Market-Makers that have not automated this process may not avail

themselves of the relief provided herein. The ability to quote 1-up shall operate on a pilot basis and shall terminate (insert date one year from date of approval).

(C) – (D) No Change.

(ii) Market Maker Trades More Than 20% Contract Volume Electronically.

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(A) No Change

(B) Continuous Quoting Obligation: A market maker will be required to maintain continuous two-sided quotes for at least ten contracts (undecrement size) in a designated percentage of series within the class, in accordance with the schedule below[:]. If the underlying primary market disseminates a 100-share quote, a Market-Maker may quote 1-up, however, this ability is expressly conditioned on the process being automated (i.e., a Market-Maker may not manually adjust his quotes to reflect 1-up sizes). Quotes must automatically return to at least 10-up when the underlying primary market no longer disseminates a 100-share quote. Market-Makers that have not automated this process may not avail themselves of the relief provided herein. The ability to quote 1-up shall operate on a pilot basis and shall terminate (insert date one year from date of approval).

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(C) No Change

Interpretations and Policies...

.01 - .04 No change

.05 Unless an options class is exempted by the appropriate Market Performance Committee, under normal market conditions a Market-Maker's bid or offer for a series of options of

unspecified size is for five contracts, except that a Market-Maker may be compelled to buy or sell a specific number of contracts at the disseminated bid or offer pursuant to his obligations under Rule 8.51. [In classes in which the CBOE Hybrid system is operational such that each market participant is deemed the responsible broker-dealer for its quotations, a Market-Maker's initial bid or offer must be accompanied by a size (for at least ten (10) contracts), indicating the number of contracts for which the Market-Maker will buy (sell) at his price.]

.06 - .13 No change

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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 received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV 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 Rules 8.7(d)(i)(B) and (d)(ii)(B), which only apply to classes trading on the Hybrid Trading System, impose a ten contract (“10-up”) minimum size requirement for market makers when such market makers quote electronically. Similarly, Interpretation .05 to CBOE Rule 8.7 imposes a 10-up size requirement for a market maker's initial bid or offer. Generally, the Exchange believes that this ten contract quoting requirement imposes a reasonable obligation on market makers, who, in turn for satisfying this and other obligations, are entitled to receive maker maker

margin treatment. Nevertheless, the Exchange believes that there are instances in which requiring market makers to quote 10-up imposes a heightened and inappropriate level of risk upon them. Accordingly, in the Exchange's view, the purpose of this filing is to adopt a limited exception to the 10-up minimum quoting requirement in one such specific instance on a one-year pilot basis.

Under this proposed exception, market makers on the Hybrid Trading System would be able to quote a size less than ten contracts whenever the underlying primary market for the option (or ETF option) disseminates a 1-up market (i.e., a market that reflects a quotation for 100 shares of the underlying security). The Exchange believes that, when the underlying market disseminates a 1-up quote, it substantially restricts the amount of liquidity available in that security to 100 shares on that particular side of the market. According to the Exchange, there is no restriction on the ability of a stock specialist in the underlying market to quote a 1-up market. The Exchange notes that options exchanges are derivative markets. In this regard, the Exchange believes that, with a minimum quote size requirement of ten contracts, when the underlying stock market is 1-up, an options exchange provides more than ten times the liquidity than does the underlying stock market. The Exchange also believes that, because an options exchange may list twenty or more options series for an underlying stock, options market makers end up providing exponentially more liquidity than is available in the underlying market.⁶ Additionally, according to the Exchange, market makers must hedge their transactions by buying and/or selling stock, and when the underlying stock exchange posts a 1-up market, it restricts the market maker's ability

⁶ For example, if a market maker posts 10-up markets in twenty series, such market maker would be providing liquidity equivalent to 20,000 shares, which would dwarf the underlying market's size commitment of 100 shares.

to hedge, which does nothing but increase such market maker's financial exposure.⁷ For these reasons, the Exchange believes that market makers in this instance should have the ability to lower their quote sizes to one contract if they choose, thereby matching the amount of liquidity provided by the underlying.

The Exchange further proposes that the ability to quote 1-up when the underlying primary is 1-up is expressly conditioned on the process being automated (i.e., a market maker may not manually adjust his quotes to reflect 1-up sizes). As part of this automation, quotes must automatically return to at least 10-up when the underlying primary market no longer disseminates a 1-up quote. Market makers that have not automated this process may not avail themselves of the relief provided herein.

The Exchange also proposes to delete the language that imposes a 10-up size requirement for a market maker's initial bid or offer in Interpretation .05 to CBOE Rule 8.7, because that language is duplicative of what is already contained in Rule 8.7(d).

The Exchange proposes that this exception operate on a one-year pilot basis. Prior to being able to participate in this pilot program, market makers or their vendors that provide their handheld quoting devices would be required to demonstrate to the Exchange that they have automated the process discussed above. Upon completion of the pilot period, the Exchange represents that it will provide to the Commission a report detailing the effectiveness of the program, along with a request either to eliminate or make permanent the pilot program.

⁷ NYSE Information memo 94-32 (August 9, 1994) indicates that 1-up markets on the NYSE can last for as long as five minutes. The Exchange believes that, during this five-minute period, options market makers without the ability to post a 1-up market themselves will become the de facto liquidity providers for that security and will be unable to hedge their transactions.

Finally, the Exchange believes that the proposal is consistent with CBOE Rule 8.51, which allows the appropriate Floor Procedure Committee to establish separate firm quote requirements for each series of option, which shall be for at least one contract for non-broker-dealer orders and broker-dealer orders. The Exchange believes that nothing in this proposal would affect a market maker's obligation to honor its firm quote requirements imposed by CBOE Rule 8.51. Accordingly, if a market maker disseminates a 1-up market, its firm quote obligation would be one contract.⁸

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act⁹ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁰ in particular, in that it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest. The Exchange believes that the proposal provides for a very limited exception to the general requirement that market maker's quotes be for a minimum ten contracts. The Exchange believes that this exception, which in the Exchange's view, is narrowly-tailored and must be automated, will provide a measure of protection to marker makers when the underlying primary market disseminates 1-up markets. Accordingly, the Exchange believes the proposal serves to enhance the incentives of market makers to quote competitively and reduces the disincentives to quote competitively.

⁸ Telephone conversation between Steve Youhn, Senior Attorney, CBOE and Hong-Anh Tran, Special Counsel, Division, Commission, on July 7, 2004.

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

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

The Exchange does not believe that the proposed rule change will impose any burden on competition that is 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 has neither solicited nor received written comments on the proposed rule change.

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

Within 35 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 the 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 arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2003-39 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2003-39. 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, 450 Fifth Street, NW, Washington, DC 20549-0609. 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 available publicly.

All submissions should refer to File Number SR-CBOE-2003-39 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Margaret H. McFarland
Deputy Secretary

¹¹ 17 CFR 200.30-3(a)(12).