

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-50079; File No. SR-CBOE-2004-44)**

**July 26, 2004**

**Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to Permanent Approval of the \$5 Quote Width Pilot Program**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 19, 2004, 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 and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice and order to solicit comments on the proposed rule change from interested persons and to grant accelerated approval to the proposed rule change.

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

In January 2004, the CBOE implemented a pilot program (“Pilot Program”), which expires on July 29, 2004, that permits quote spread parameters of up to \$5, regardless of the price of the bid, for up to 200 options classes traded on the CBOE’s Hybrid Trading System (“Hybrid”).<sup>3</sup> The CBOE subsequently expanded the Pilot Program to include all options classes traded on Hybrid<sup>4</sup> and limited the applicability of the \$5 quote spreads permitted under the Pilot Program to

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release Nos. 49153 (January 29, 2004), 69 FR 5620 (February 5, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2003-50) (“Pilot Notice”); and 49919 (June 25, 2004), 69 FR 40424 (notice of filing and immediate effectiveness of File No. SR-CBOE-2004-36) (extending the Pilot Program through July 29, 2004).

<sup>4</sup> See Securities Exchange Act Release No. 49318 (February 25, 2004), 69 FR 10085 (March 3, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2004-10) (“February Notice”).

quotations that are submitted electronically to Hybrid.<sup>5</sup> The CBOE requests permanent approval of the Pilot Program.

## **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 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**

The Pilot Program became effective in January 2004 and designated 200 options classes that could be quoted with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid.<sup>6</sup> In February 2004, the CBOE expanded the number of options classes in the Pilot Program to include all options classes trading on Hybrid.<sup>7</sup> The CBOE subsequently limited the applicability of the \$5 quote spreads permitted under the Pilot Program to quotations that are submitted electronically to Hybrid.<sup>8</sup>

The Pilot Program expires on July 29, 2004. As part of the Pilot Program, the CBOE prepared and submitted to the Commission a report assessing the operation of the Pilot Program

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<sup>5</sup> See Securities Exchange Act Release No. 49791 (June 2, 2004), 69 FR 32389 (June 9, 2004) (order approving File No. SR-CBOE-2004-20) ("June Order").

<sup>6</sup> See Pilot Notice, supra note 3.

<sup>7</sup> See February Notice, supra note 4.

<sup>8</sup> See June Order, supra note 5.

and, in particular, the quality of the quotations for the options included in the Pilot Program. Specifically, the CBOE's Pilot Program report compared and analyzed the Average Quote Width Analysis ("AQWA") scores for each stock included in the Pilot Program prior to the implementation of the Pilot Program and during the operation of the Pilot Program.

According to the CBOE, the Pilot Program report indicates that the implementation of \$5 quote widths had no deleterious effects on average quote widths during the pilot period. To the contrary, the CBOE maintains that the implementation of the Pilot Program had little, if any, effect on average AQWA scores.

The CBOE believes that the Pilot Program has been successful and has helped to contribute to the maintenance of efficient markets. The CBOE notes that, as it expected, the statistics in the Pilot Program report show that market makers in any particular options class did not widen their quotes to the maximum allowable \$5 width at all times. Instead, the CBOE believes that the Pilot Program provided market makers with a tool to manage their risk when they believed that wider quotes were necessary. The CBOE notes that in an environment with high degrees of both intra- and inter-market competition, a market maker that consistently quotes \$5 wide at all times likely will never trade. Nevertheless, the CBOE notes that there are instances when a market maker may need to widen his or her quotes and, in this regard, the ability to quote \$5 wide gives some measure of protection to the market maker.<sup>9</sup> The CBOE believes that this is where the Pilot Program has been most beneficial.

The CBOE notes that on July 12, 2004, the Commission approved a CBOE proposal to allow the introduction of competing e-Designated Primary Market Makers ("e-DPMs") on the

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<sup>9</sup> CBOE Rule 8.7(d) imposes a minimum quote size obligation of 10 contracts on market makers. The CBOE notes that market makers may not quote lower than this number even if the underlying market has disseminated erroneous quotes or reported bad trades. According to the CBOE, in the absence of the ability to quote one-up, quoting \$5 wide is one of the few remaining methods by which a market maker may limit his or her risk.

CBOE.<sup>10</sup> According to the CBOE, e-DPMs will effectively function as remote competing specialists in the most active Hybrid classes. The CBOE believes that adding more well-capitalized quoters may greatly increase the already robust level of intramarket competition, thereby contributing to even greater depth of markets and more competitively-priced quotes. For these reasons, the CBOE asks the Commission to permanently approve the Pilot Program.

## 2. Statutory Basis

The CBOE believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>11</sup> Specifically, the CBOE believes the proposed rule change is consistent with the Section 6(b)(5)<sup>12</sup> requirements that the rules of an exchange be 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.

### 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 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

No written comments were solicited or received.

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<sup>10</sup> See Securities Exchange Act Release No. 50003 (July 12, 2004), 69 FR 43028 (July 19, 2004) (order approving File No. SR-CBOE-2004-24).

<sup>11</sup> 15 U.S.C. 78f(b).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

### **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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-44 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-2004-44. 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. 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-2004-44 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 review, 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.<sup>13</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act<sup>14</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, 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.

Although the Commission believes generally that maximum quotation spread parameters in the options market could provide an important safeguard to ensure that market maker quotes in options are not unnecessarily wide,<sup>15</sup> the Commission believes that the CBOE's Hybrid system provides sufficiently strong incentives for market makers submitting quotations electronically to Hybrid to disseminate competitive quotations without maximum quotation spread parameters.<sup>16</sup> In this regard, the Commission notes that in Hybrid each market maker quotes independently, customers and broker-dealers may enter orders in the limit order book at

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<sup>13</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>14</sup> 15 U.S.C. 78f(b)(5).

<sup>15</sup> See e.g., Securities Exchange Act Release No. 47532 (March 19, 2003), 68 FR 55685 (March 26, 2003) (order approving File No. SR-ISE-2001-15) (establishing a six-month pilot program permitting \$5 quotation spreads in up to 50 options classes on the International Securities Exchange, Inc.).

prices better than those posted by market makers, and incoming orders are allocated based on the price and size of orders and quotes resting in the book.<sup>17</sup> Under the CBOE's matching algorithm, the larger the size of a market maker's quotation at the best price, the greater the size of the allocation he or she receives.<sup>18</sup> The Commission believes that these attributes and rules of the CBOE provide strong market incentives for market makers submitting quotations electronically to Hybrid to maintain narrow and competitive quotation spreads.

The Commission believes that the Pilot Program report submitted by the CBOE indicates that the spreads in market maker quotations submitted electronically to Hybrid did not widen significantly during the operation of the Pilot Program. Accordingly, the Commission believes that permanent approval of the Pilot Program is consistent with the Act.

The Commission finds good cause for approving the proposal prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. As noted above, the CBOE's Pilot Program report indicated that the spreads in market maker quotations submitted electronically to Hybrid did not widen significantly during the operation of the Pilot Program. In addition, the CBOE's Pilot Program is substantially similar to a pilot program implemented by the International Securities Exchange, Inc. ("ISE"), that the Commission approved permanently.<sup>19</sup> The Commission received no comments on either the ISE's pilot program or the CBOE's Pilot Program. Accordingly, the Commission believes that good cause exists,

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<sup>16</sup> As noted above, the \$5 quotation spreads permitted under the Pilot Program apply only to quotations that are submitted electronically to Hybrid. See June Order, supra note 5.

<sup>17</sup> See Pilot Notice, supra note 3.

<sup>18</sup> See Pilot Notice, supra note 3.

<sup>19</sup> See Securities Exchange Act Release No. 50015 (July 14, 2004), 69 FR 43872 (July 22, 2004) (order approving File No. SR-ISE-2003-22).

consistent with Sections 6(b)(5) and 19(b)(2) of the Act,<sup>20</sup> to grant accelerated approval to the proposal.

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<sup>20</sup> 15 U.S.C. 78f(b)(5) and 78s(b)(2).



**V. Conclusion**

For the foregoing reasons, the Commission finds that the proposal is consistent with the requirements of the Act and rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>21</sup> that the proposed rule change (SR-CBOE-2004-44) is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>21</sup> 15 U.S.C. 78s(b)(2).

<sup>22</sup> 17 CFR 200.30-3(a)(12).