

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50205; File No. SR-CBOE-2003-39)

August 17, 2004

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendments No. 1, 2, and 3 Thereto by the Chicago Board Options Exchange, Inc. Relating to Quote Sizes

On September 12, 2003, the Chicago Board Options Exchange, Inc. (“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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to establish a one-year pilot program that would allow market makers on CBOE’s Hybrid Trading System (“Hybrid”) to disseminate a quotation with a size of less than ten contracts under certain limited circumstances. On October 29, 2003, the CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On June 10, 2004, the CBOE filed Amendment No. 2 to the proposed rule change.<sup>4</sup> On June 28, 2004, the CBOE filed Amendment No. 3 to the proposed rule change.<sup>5</sup> The proposed rule change, as amended, was published for comment in the Federal Register on July 15, 2004.<sup>6</sup> The Commission received no comments on the proposal.

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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 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”).

<sup>4</sup> 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.

<sup>5</sup> 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.

<sup>6</sup> See Securities Exchange Act Release No. 49990 (July 8, 2004), 69 FR 42473 (“Notice”).

This order approves the proposed rule change, as amended, on a pilot basis through August 17, 2005.

CBOE Rules 8.7(d)(i)(B) and (d)(ii)(B), which only apply to classes trading on Hybrid, impose a ten contract (“10-up”) minimum quotation size requirement for CBOE market makers when such market makers quote electronically. Similarly, Interpretation .05 to CBOE Rule 8.7 imposes a 10-up minimum quotation size requirement for a CBOE market maker’s initial bid or offer in classes in which Hybrid is operational.

The Exchange proposes, on a one-year pilot basis, an exception to CBOE Rules 8.7(d)(i)(B) and (d)(ii)(B) to allow market makers on Hybrid to disseminate a quotation with a size of 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).

In order to participate in the pilot program, a CBOE market maker (or the vendor that provides handheld quoting devices for the market maker) would be required to demonstrate to the Exchange that it has automated the process for adjusting the market maker’s quotations to reflect sizes of less than ten contracts in the event the underlying primary market disseminates a 1-up market and to reflect sizes of at least ten contracts when the underlying primary market no longer disseminates a 1-up market. CBOE market makers that have not automated this process would not be permitted to avail themselves of the exception provided by the proposed rule change, as amended. In addition, the Exchange represents that it would 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.<sup>7</sup>

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<sup>7</sup> Id.

The Exchange also proposes to delete the language that imposes a 10-up minimum quotation size requirement for a CBOE 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 CBOE Rule 8.7(d).

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b) of the Act<sup>8</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>9</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,<sup>10</sup> 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. The Commission believes that CBOE Rules 8.7(d)(i)(B) and (d)(ii)(B), which currently provide for a ten-contract minimum quotation size requirement, impose a reasonable obligation on CBOE market makers, who, in turn for satisfying this and other obligations, are entitled to receive good faith margin treatment. The Commission also believes that it may be reasonable for the Exchange to reduce to one contract, on a one-year pilot basis, the minimum quotation size requirement for market makers, in event that the underlying primary market disseminates a 1-up market, because (1) specialists in the underlying stock are allowed to disseminate 1-up markets and (2) the amount of liquidity available for CBOE market makers to hedge their options positions by purchasing or selling shares in the underlying market may be reduced when the underlying market disseminates a 1-up quote.

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<sup>8</sup> 15 U.S.C. 78f(b).

<sup>9</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>10</sup> 15 U.S.C. 78f(b)(5).

The Commission notes that the process for adjusting the size of a market maker's quotations in the event the underlying primary market disseminates a 1-up market must be automated and that this automated process should reduce any delays in re-adjusting the quotations to reflect a 10-up market when the underlying primary market no longer disseminates a 1-up market. In addition, the Commission believes that the approval of the proposal on a one-year pilot basis should provide the CBOE and the Commission with an opportunity to review the operation of the proposal and to address any potential concerns that may arise. Further, the Commission notes that the CBOE agreed to provide the Commission with a report detailing the effectiveness of the pilot program. In order to efficiently evaluate the effectiveness of the pilot program, the Commission expects the CBOE to provide its report by June 17, 2005.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>11</sup> that the proposed rule change (SR-CBOE-2003-39) and Amendments No. 1, 2, and 3 are approved, as a pilot program until August 17, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>11</sup> 15 U.S.C. 78s(b)(2).

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