

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50292; File No. SR-CBOE-2004-39)

August 31, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Inc. Relating to Extending a Limited Pilot Program for Maximum Bid/Ask Differentials

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 7, 2004, the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) submitted 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 August 19, 2004, the Exchange filed Amendment No. 1 to the proposed rule change.³ In Amendment No. 1, CBOE changed the filing from a proposed rule change filed under Section 19(b)(2) of the Act⁴ to one filed under Section 19(b)(3)(A) of the Act.⁵ Specifically, the Exchange designated its filing as non-controversial pursuant Section 19(b)(3)(A)(iii) of the Act⁶ and to Rule 19b-4(f)(6).⁷ Accordingly, the proposed rule change became effective upon filing Amendment No. 1 on August 19, 2004. The Commission is publishing this notice, as amended, to solicit comments on the proposed rule change from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Angelo Evangelou, Senior Attorney, CBOE, to Kelly M. Riley, Assistant Director, Division of Market Regulation, Commission, dated August 19, 2004 (“Amendment No. 1”). In Amendment No. 1, the Exchange submitted a new Form 19b-4, which replaced and superseded the original filing in its entirety.

⁴ 15 U.S.C. 78s(b)(2).

⁵ 15 U.S.C. 78s(b)(3)(A).

⁶ 15 U.S.C. 78s(b)(3)(A)(iii).

⁷ 17 CFR 240.19b-4(f)(6).

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

The Exchange proposes to amend its rules to extend a limited pilot program relating to maximum bid/ask differentials.⁸ The text of the proposed rule change, as amended, is available at the offices of the Exchange and the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE 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. CBOE 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 Exchange is proposing to extend a limited pilot exemption to the Market-Maker bid/ask differential requirements contained in CBOE Rule 8.7(b)(iv). As part of accommodating compliance with the Linkage Plan,⁹ the Exchange introduced an "autofade" functionality which causes one side of CBOE's disseminated quote to move to an inferior price when the quote is required to fade pursuant to the terms of the Linkage Plan and/or when the size associated with the quote has been depleted by the Retail Automatic Execution System ("RAES") (of both Linkage orders and non-Linkage orders).

⁸ See Securities Exchange Act Release No. 48471 (September 10, 2003), 68 FR 54251 (September 16, 2003) (SR-CBOE-2003-08).

⁹ The Plan for the Purpose of Creating and Operating an Intermarket Options Linkage ("Linkage Plan") was originally approved on July 28, 2000. See Securities Exchange Act Release No. 43086, 65 FR 48023 August 4, 2000).

Linkage orders are generally Immediate or Cancel limit orders priced at the national best bid or offer (“NBBO”) that must be acted upon within 15-seconds. The Linkage Plan provides several instances in which a Participant receiving a linkage order must fade its quote. For example, if a Participant receives a Principal Acting as Agent (“PA”) order for a size greater than the Firm Customer Quote Size and does not execute the entirety of the PA Order within 15 seconds, the Participant is required to fade its quote. CBOE's autofade functionality automates the fading process to ensure that members (and the Exchange) are in full compliance with this aspect of the Linkage Plan. Autofade moves CBOE's quote to a price that is 1-tick inferior to the NBBO.¹⁰ This ensures that the Exchange will not immediately receive additional linkage orders to allow the member to refresh the quote (either manually or through an autoquote update).

As mentioned above, autofade also applies anytime an automatic execution (of any order) via RAES has depleted the size of CBOE's quote. Once a quote is exhausted, autofade moves the quote to a price that is 1-tick inferior to the NBBO (as described above). Autofade is only necessary for classes that are not on the Exchange Hybrid System. Thus, this exemption is only needed until the full rollout of the Hybrid System is completed.

For equity option classes that are not trading on the Hybrid System, the CBOE quote is generally derived from an autoquote system that is maintained by the Designated Primary Market-Maker (“DPM”). Certain DPMs utilize an Exchange-provided autoquote system while others employ proprietary autoquote systems. In either case, the autoquote system calculates bid and ask prices that are transmitted to the Exchange for dissemination to the Options Price Reporting Authority (“OPRA”). The DPM and the trading crowd separately input the size

¹⁰ The only exception is when CBOE's NBBO quote (or next best quote) is represented by a customer order in the book. In such cases, the Exchange does not fade a booked order (it would have to be traded).

associated with the bid/ask prices. When an automatic execution occurs through the RAES system, the size associated with the quote is decremented until it is exhausted. However, because the autoquote system is only calculating prices and not quote sizes, the autoquote system is not aware that the size has been exhausted (or in the case of a remaining balance on a Linkage order, that the quote needs to fade in order to comply with the Linkage Plan). Therefore, the autofade functionality was built to override autoquote and move the quote price to 1-tick inferior to the NBBO. The “override” period only lasts for 30 seconds. However, the override can be overridden during that 30-second time period if the quote is manually updated by a trader or if the autoquote system transmits new bid/ask pricing to the Exchange.

The exemption is for limited instances where the autofade functionality moves the quote in a manner that causes the quote width to widen beyond the bid/ask parameters provided pursuant to CBOE Rule 8.7(b)(iv). CBOE seeks to extend on a pilot basis the temporary exception to the requirements of CBOE Rule 8.7(b)(iv) in cases where autofade causes a quote that exceeds the quote width parameters of that rule. The proposed exemption period lasts for a maximum of 30 seconds after any given autofade that caused a wider quote than allowed under CBOE Rule 8.7(b)(iv). Thus, to the extent a quote remained outside of the maximum width after the 30-second time period, the responsible broker or dealer disseminating the quote would be deemed in violation of CBOE Rule 8.7(b)(iv) for regulatory purposes. CBOE proposes that the pilot run until February 17, 2006 (for 18 months) when all multiply listed classes are trading on CBOE’s Hybrid Trading System.

2. Statutory Basis

The Exchange represents that the proposed rule change, as amended, will, among other things, allow the Exchange to more easily comply with the requirements of the Linkage Plan.

Accordingly, the Exchange believes the proposed rule change, as amended, is consistent with Section 6(b) of the Act¹¹ in general and furthers the objectives of Section 6(b)(5)¹² in particular in that it promotes just and equitable principles of trade, serves to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest.

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

The Exchange believes that the proposed rule change does not 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

No written comments were solicited or received with respect to the proposed rule change.

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

The foregoing rule has become effective pursuant to Section 19(b)(3)(A) of the Act¹³ and Rule 19b-4(f)(6) thereunder¹⁴ because the foregoing proposed rule does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change at least five business days prior to the filing date of the proposed rule change. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the

¹¹ 15 U.S.C. 78f(b).

¹² 15 U.S.C. 78f(b)(5).

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.¹⁵

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-2004-39 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-2004-39. 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

¹⁵ For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act, the Commission considers that period to commence on August 19, 2004, the date CBOE filed Amendment No. 1 to the proposed rule change. See 15 U.S.C. 78s(b)(3)(C).

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 offices of 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-2004-39 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.¹⁶

Margaret H. McFarland
Deputy Secretary

¹⁶ 17 CFR 200.30-3(a)(12).