

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50967; File No. SR-CBOE-2004-72)

January 5, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Chicago Board Options Exchange, Incorporated Relating to the SizeQuote Mechanism

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 November 10, 2004, the Chicago Board Options Exchange, Incorporated (“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 CBOE. On December 22, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The CBOE proposes to adopt a SizeQuote Mechanism for the execution of large-sized orders in open outcry. The text of the proposed rule change is below. Proposed new language is in italics.

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**Rule 6.74 “Crossing Orders”**

(a) – (e) No change

(f) Open Outcry “SizeQuote” Mechanism

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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> Amendment No. 1 replaces the original filing in its entirety. See e-mail message from Stephen Youhn, Assistant Secretary, CBOE, to Yvonne Fraticelli, Special Counsel, Division of Market Regulation, Commission, on January 5, 2005.

(i) SizeQuotes Generally: The SizeQuote Mechanism is a process by which a floor broker (“FB”) may execute and facilitate large-sized orders in open outcry. Floor brokers must be willing to facilitate the entire size of the order for which they request SizeQuotes (the “SizeQuote Order”). The appropriate Market Performance Committee shall determine the classes in which the SizeQuote Mechanism shall apply. The SizeQuote Mechanism will operate as a pilot program which expires [insert date one year from date of approval].

- (A) Eligible Order Size: The appropriate MPC shall establish the eligible order size however such size shall not be less than 250 contracts.
- (B) In-crowd Market Participants: The term “in-crowd market participants” (“ICMPs”) shall be as defined in CBOE Rule 6.45A.
- (C) Public Customer Priority: Public customer orders in the electronic book have priority to trade with a SizeQuote order over any ICMP providing a SizeQuote response at the same price as the order in the electronic book.
- (D) DPM Participation Rights: The DPM participation entitlement shall not apply to SizeQuote transactions.
- (E) FBs may not execute a SizeQuote order at a price inferior to the national best bid or offer (“NBBO.”) Unless a SizeQuote request is properly canceled in accordance with paragraph (iv), a FB is obligated to execute the entire SizeQuote order at a price that is not inferior to the NBBO in situations where there are no SizeQuote responses received or where such responses are inferior to the NBBO.

(ii) SizeQuote Procedure: Upon request by a FB for a SizeQuote, ICMPs may respond with indications of the price and size at which they would be willing to trade with a SizeQuote order. After the conclusion of time during which interested ICMPs have been given the opportunity to provide their indications, the FB must execute the SizeQuote order with ICMPs and/or with a firm facilitation order in accordance with the following procedures:

- (A) Executing the Order at ICMP's Best Price: ICMPs that provided SizeQuote responses at the highest bid or lowest offer ("best price") have priority to trade with the SizeQuote Order at that best price. Allocation of the order among ICMPs shall be prorata, up to the size of each ICMP's SizeQuote response. The FB must trade at the best price any contracts remaining in the original SizeQuote Order that were not executed by ICMPs providing SizeQuote responses.
- (B) Executing the Order at a Price that Improves upon ICMP's Price by One Minimum Increment: ICMPs that provided SizeQuote responses at the best price ("eligible ICMPs") have priority to trade with the SizeQuote Order at a price equal to one trading increment better than the best price ("improved best price"). Allocation of the order among eligible ICMPs at the improved best price shall be prorata, up to the size of each eligible ICMP's SizeQuote response. The FB must trade at the improved best price any contracts remaining in the original SizeQuote Order that were not executed by eligible ICMPs.

(C) Trading at a Price that Improves upon ICMP's Price by More than One Minimum Increment: A FB may execute the entire SizeQuote order at a price two trading increments better than the best price communicated by the ICMPs in their responses to the SizeQuote request.

(iii) Definition of Trading Increments: Permissible trading increments are \$0.05 for options quoted below \$3.00 and \$0.10 for all others. In classes in which bid-ask relief is granted pursuant to CBOE Rule 8.7(b)(iv), the permissible trading increments shall also increase by the corresponding amount. For example, if a series trading above \$3.00 has double-width bid-ask relief, the permissible trading increment for purposes of this rule shall be \$0.20.

(iv) It will be a violation of a FB's duty of best execution to its customer if it were to cancel a SizeQuote order to avoid execution of the order at a better price. The availability of the SizeQuote Mechanism does not alter a FB's best execution duty to get the best price for its customer. A SizeQuote request can be canceled prior to the receipt by the FB of responses to the SizeQuote request. Once the FB receives a response to the SizeQuote request, if he/she were to cancel the order and then subsequently attempt to execute the order at an inferior price to the previous SizeQuote response, there would be a presumption that the FB did so to avoid execution of its customer order in whole or in part by others at the better price.

### **Interpretations and Policies. . . .**

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 parts of such statements.

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

CBOE rules impose several obligations upon floor brokers ("FBs"), including the requirement in paragraph (a) of CBOE Rule 6.73, "Responsibilities of Floor Brokers," that a FB handling an order use due diligence in executing that order at the best price(s) available. CBOE Rule 6.73.01 supplements this general requirement by requiring FBs to ascertain whether a better price than those currently displayed in the limit order book is available in the trading crowd. In order to assist FBs in their exercise of due diligence, the Exchange believes it would be beneficial to adopt new procedures governing the execution of certain large-sized orders, which by virtue of their large size often require specialized handling. The purpose of this rule filing, therefore, is to adopt on a one-year pilot basis a trading procedure mechanism called the SizeQuote Mechanism for use by FBs in their representation of large-sized orders in open outcry.<sup>4</sup>

The SizeQuote Mechanism is a process by which a FB, in his/her exercise of due diligence to execute orders at the best price(s), may execute and facilitate large-sized orders in

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<sup>4</sup> The Exchange in the original rule filing proposed including the rule text describing the SizeQuote Mechanism in CBOE Rule 6.73, "Responsibilities of Floor Brokers." Amendment No. 1 relocates the same text to CBOE Rule 6.74, "Crossing Orders," with the technical changes as described herein.

open outcry. For purposes of this rule, the minimum qualifying order size is 250 contracts<sup>5</sup> and FBs must stand ready to facilitate the entire size of the order for which they request SizeQuotes (the “SizeQuote Order”). The SizeQuote procedure works as follows:

A FB holding an order for at least 250 contracts must specifically request a SizeQuote from in-crowd market participants (“ICMPs”).<sup>6</sup> Upon such a request by a FB, ICMPs may respond with indications of the price and size at which they would be willing to trade with a SizeQuote Order. ICMPs may respond with any size and price they desire (subject to the rules governing the current market maker obligation requirements) and as such are not obligated to respond with a size of at least 250 contracts.<sup>7</sup> The proposal provides that FBs may not execute a SizeQuote Order at a price inferior to the NBBO. Proposed paragraph (f)(i)(E) clarifies that unless a SizeQuote request is properly canceled in accordance with paragraph (iv), a FB is obligated to execute the entire SizeQuote Order at a price that is not inferior to the NBBO in situations where there are no SizeQuote responses received or where such responses are inferior to the NBBO.

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<sup>5</sup> The appropriate Exchange committee will determine the classes in which SizeQuote operates and may vary the minimum qualifying order size, provided such number may not be less than 250 contracts.

<sup>6</sup> Pursuant to CBOE Rule 6.45A, “Priority and Allocation of Trades for CBOE Hybrid System,” in-crowd market participants include in-crowd Market-Makers, an in-crowd DPM, and a floor broker representing orders in the trading crowd.

<sup>7</sup> CBOE Rule 8.7(d), “Market Making Obligations Applicable to Hybrid Classes,” requires Market-Makers to respond to any request by a FB for a market with a legal-width (as defined in CBOE Rule 8.7(b)(iv)), 10-contract minimum size quote in classes trading on the CBOE Hybrid System.

After the conclusion of time during which interested ICMPs have been given the opportunity to provide their indications, the FB will execute the SizeQuote Order he is holding with ICMPs or with a facilitation order, or both, in accordance with the following procedures:<sup>8</sup>

**Executing the SizeQuote Order at ICMP's Best Price:** ICMPs that provided SizeQuote responses at the highest bid or lowest offer ("best price") have priority to trade with the SizeQuote Order at that best price. For example, assume a FB requests a SizeQuote and ICMPs respond with a market quote of \$1.00 – 1.20 for 1,000 contracts. This quote constitutes the "best price" and those ICMPs that responded have priority at those prices.<sup>9</sup> If the FB chooses to trade at either of those prices, the SizeQuote Order will be allocated pro-rata to those ICMPs that responded with a quote at the best price, up to the size of their respective quotes.<sup>10</sup> If in the above example the SizeQuote Order is for more than 1,000 contracts, the FB must trade the balance with a facilitation order at the best price. ICMPs that did not respond to the SizeQuote request would not be eligible to participate in the allocation of this trade.

**Executing the Order at a Price that Improves upon ICMP's Price by One Minimum Increment:**<sup>11</sup> ICMPs that provided SizeQuote responses at the best price ("eligible ICMPs") have priority to trade with the SizeQuote Order at a price equal to one minimum increment better than the best price ("improved best price"). Accordingly, using the example above, eligible

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<sup>8</sup> The FB will execute the SizeQuote Order either with ICMPs or with a firm facilitation order, or both, in accordance with the requirements of paragraph (ii).

<sup>9</sup> Public customers in the electronic book have priority to trade with a SizeQuote Order over any ICMP providing a SizeQuote response at the same price as the order in the electronic book. See proposed CBOE Rule 6.74(f)(i)(C). This example assumes there are no public customer orders at the SizeQuote response price.

<sup>10</sup> There will be no DPM participation entitlement in SizeQuote trades, even if the DPM is among those ICMPs quoting at the best price.

<sup>11</sup> Minimum increments are governed by CBOE Rule 6.42, "Minimum Increments for Bids and Offers." The term "minimum increment" is synonymous with "trading increment."

ICMPs, if they desire, have priority at prices of \$1.05 and \$1.15 of up to 1,000 contracts.<sup>12</sup> If the FB chooses to trade at either of those prices, the SizeQuote Order will be allocated pro-rata at the improved best price to those eligible ICMPs that responded with a quote at the best price, up to the size of their respective quotes. If the SizeQuote Order is for more than 1,000 contracts, the FB must trade the balance with a facilitation order at the improved best price. ICMPs that did not respond to the SizeQuote request would not be eligible to participate in the allocation of this trade.

**Trading at a Price that Improves upon ICMP's Price by More than One Minimum Increment:** A FB may execute the entire SizeQuote Order with a facilitation order at a price two minimum increments better than the best price communicated by the ICMPs in their responses to the SizeQuote request. Using the example above, a FB could trade the SizeQuote Order with a facilitation order at \$1.10. ICMPs would not be able to participate in the trade at that price.

The Exchange also proposes to adopt new paragraph (iv) to explicitly state that it will be a violation of a FB's duty of best execution to its customer if it were to cancel a SizeQuote Order to avoid execution of the order at a better price. The availability of the SizeQuote Mechanism does not alter a FB's best execution duty to get the best price for its customer. A SizeQuote request can be canceled prior to the receipt by the FB of responses to the SizeQuote request. Once the floor broker receives a response to the SizeQuote request, if he/she were to cancel the order and then subsequently attempt to execute the order at an inferior price to the previous SizeQuote response, there would be a presumption that the FB did so to avoid execution of its customer order in whole or in part by others at the better price.

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<sup>12</sup> Obviously, there is no obligation requiring an ICMP to trade at a price that is better than his/her verbal quote.

The Exchange represents that it will provide to the Commission at the end of the pilot period a report summarizing the effectiveness of the SizeQuote program. Pending a report that indicates that the SizeQuote program has been successful, the Exchange anticipates submitting a rule filing that either requests extension of the SizeQuote program or permanent approval of the pilot.

The Exchange believes that the SizeQuote proposal provides a well-balanced mechanism that enhances the trading crowd's ability to quote competitively and participate in open outcry trades while at the same time it creates a process that gives greater certainty to FBs in the execution of large orders. Under the proposal, ICMPs not only will have priority at the price of the quote they give in response to a SizeQuote request, but they also will have priority, if they want it, at a price that is one trading increment better than their quote. FBs will now have more certainty in that ICMPs will have one opportunity to respond with a quote response and if they do not, they will not participate in the trade. Moreover, once an ICMP gives his/her best price (i.e., SizeQuote response), he/she may not subsequently change the terms of that response after the FB announces its intention to trade, although the ICMP will have priority at a price that is one trading increment better than his/her quote. This further enhances ICMPs' incentives to quote competitively.

The Exchange also believes that the proposal enhances an ICMP's incentive to quote competitively by giving complete priority at not only his/her price but also at one trading increment better than his/her SizeQuote response. For these reasons, 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>13</sup> Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)<sup>14</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

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

The Exchange 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 such 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 is consistent with the Act. Comments may be submitted by any of the following methods:

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<sup>13</sup> 15 U.S.C. 78f(b).

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

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-2004-72 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-2004-72. 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-2004-72 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.<sup>15</sup>

J. Lynn Taylor  
Assistant Secretary

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<sup>15</sup> 17 CFR 200.30-3(a)(12).