

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51107; File No. SR-CBOE-2004-75)

January 31, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendments No. 1 and 2 Thereto by the Chicago Board Options Exchange, Incorporated Relating to the Introduction of Remote Market-Makers

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 22, 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 CBOE. On January 10, 2005, CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On January 21, 2005, CBOE filed Amendment No. 2 to the proposed rule change.<sup>4</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

CBOE proposes to adopt rules authorizing remote market making. The text of the proposed rule change is available on the CBOE’s Web site (<http://www.cboe.com>), at the CBOE’s Office of the Secretary, and at the Commission’s Public Reference Room.

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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 and supercedes CBOE’s original 19b-4 filing in its entirety.

<sup>4</sup> Amendment No. 2 replaces and supercedes CBOE’s original 19b-4 filing and Amendment No. 1 in their entirety.

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's Hybrid Trading System merges the electronic and open outcry trading models, offering market participants the ability to stream electronically their own firm disseminated market quotes representing their trading interest. The current Hybrid rules allow Market-Makers ("Market-Maker" or "MMs" or "market maker") to stream electronic quotes only when they are physically present in their appointed trading stations. This requirement prevents "remote market making," a practice whereby Market-Makers may submit quotes from locations outside of the physical trading station for that class.

CBOE proposes to adopt rules accommodating remote market making. To this end, CBOE proposes to authorize a new membership status called Remote Market-Maker ("RMM"). RMMs would have the ability to submit quotes to the CBOE from a location outside of the physical trading station for the subject class. To accommodate RMMs, the Exchange proposes to amend existing, and adopt new, rules addressing RMM obligations, RMM appointments, Priority and Allocation of Trades, and Evaluation of RMMs, as described below.

### **CBOE Rule 8.1      Market-Maker Defined**

The Exchange proposes to amend CBOE Rule 8.1 to eliminate from the definition of Market-Maker the requirement that transactions be effected on the trading floor. Transactions by market makers that comply with the requirements of CBOE Rule 8.7.03 would be considered market maker transactions.<sup>5</sup> The Exchange also proposes to clarify that the term market maker includes an RMM.

### **CBOE Rule 8.3      Appointment of Market-Makers**

The Exchange proposes to amend CBOE Rule 8.3 to clarify its non-applicability to RMMs.

### **CBOE Rule 8.4      RMMs**

The Exchange proposes to adopt new CBOE Rule 8.4 to address the definitional, registration, affiliation, and appointment issues relating to RMMs. Proposed CBOE Rule 8.4(a) defines an RMM as an individual member or member organization registered with the Exchange that makes transactions as a dealer-specialist from a location other than the physical trading station for the subject class. The rule also proposes that transactions of RMMs that are executed on the Exchange are deemed MM transactions for purposes of Chapter VIII of the CBOE Rules and CBOE Rules 3.1 and 12.3(f).

Proposed paragraph (b), Registration and Approval of RMMs, provides that the registration and approval of RMMs would be in accordance with CBOE Rule 8.2.<sup>6</sup> As a result, RMMs would be approved in the same manner that MMs are approved and any member approved as a MM would be approved as an RMM upon requesting RMM status with the

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<sup>5</sup> CBOE Rule 8.7.03 is discussed in greater detail below.

<sup>6</sup> The Exchange proposes a corresponding change to CBOE Rule 8.2(a) to provide that applicants must pass a member's exam as opposed to a floor member's exam.

Exchange's Membership department. An RMM retains its approval to act as an RMM until the RMM requests the Exchange to relieve it of its approval to act as an RMM and the Exchange grants such approval or until the Exchange terminates its approval to act as an RMM pursuant to Exchange Rules.<sup>7</sup> Proposed paragraph (b) also states that an RMM may not transfer its approval to act as an RMM unless approved by the Exchange.

Proposed paragraph (c) governs affiliation limitations and provides that except as provided in subparagraphs (i) and (ii), an RMM may not have an appointment as an RMM in any class in which it or its member organization serves as Designated Primary Market-Maker ("DPM"), electronic DPM ("e-DPM"), RMM, or MM on CBOE. Subparagraph (i) proposes an exception to allow a CBOE Member or Member Firm operating as an RMM in a class to have, as part of an 18-month pilot program, one MM affiliated with the RMM organization trading in open outcry in any specific option class allocated to the RMM, provided such market maker trades on a separate membership.<sup>8</sup> This is identical to the e-DPM pilot program in which an e-DPM also may have an affiliated MM in the same class.<sup>9</sup>

Subparagraph (ii) proposes an exception to allow a CBOE Member or Member Firm to have, as part of a 12-month pilot program, multiple aggregation units operating as separate RMMs within the same class provided specific criteria are satisfied. CBOE believes there to be three primary instances in which this proposed multiple aggregation unit exception would be

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<sup>7</sup> The termination of an RMM's approval to act as an RMM would be pursuant to proposed CBOE Rules 8.61 or 8.4(e).

<sup>8</sup> As part of the pilot program, CBOE represents that it would confidentially provide the Commission with data on (1) the size of orders that RMMs and affiliated MMs both trade with electronically; (2) the price and size of the RMM's and the affiliated MM's respective quotes; (3) the price and size of quotes of other participants in classes where an RMM and an affiliate are quoting; and, (4) a breakdown of how orders are allocated to the RMM, the affiliated MM, and any other participants.

<sup>9</sup> See CBOE Rule 8.93(vii).

utilized. For example, large broker-dealers (“BDs”) are divided into desks that pursue separate trading strategies, and each of these trading desks may be interested in serving in an RMM capacity. Without an aggregation unit exception, each BD would be limited to only one RMM, regardless of the number of trading desks it employs and regardless of the degree of autonomy or separation between each desk.

Second, a common organizational structure utilized by CBOE MMs involves a common financial backer providing capital to multiple independent, unaffiliated MMs. Each of these MMs trades independently and has its own profit-loss account that is separate and distinct from that of the other MMs receiving financial backing from the same entity. Without an aggregation unit exception, these independent MMs could be viewed as affiliated and thus be precluded from being RMMs in the same classes. Third, given the rapidly escalating costs of acquiring sophisticated quoting technology, many MMs, in an effort to reduce their operating costs, have pooled resources to acquire such technology. Despite the shared expenses and pooled resources, these MMs continue to operate independently with their own separate profit-loss accounts, which are unaffected by the profitability (or lack thereof) of others with whom they have shared costs/pooled resources. Without the ability for each MM to be treated as an aggregation unit, these MMs would be precluded from trading as RMMs within the same classes.

In this regard, CBOE proposes to allow multiple aggregation units to operate as RMMs in the same class provided they comply with the following criteria.<sup>10</sup>

- (A) The member or member firm has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent

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<sup>10</sup> These criteria are based on the criteria contained in Regulation SHO, which was recently adopted by the Commission. Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (File No. S7-23-03).

identity. The independence of aggregation units may be evidenced by separate management structures, location, business purpose, or separate profit-and-loss treatment within the member firm. Each aggregation unit must maintain all trading activity of that aggregation unit in a segregated account, which would be reported to the Exchange as such.

(B) Each aggregation unit must operate independently of other aggregation units of the member or member firm. Moreover, all traders in an aggregation unit may pursue only the trading objectives or strategy(ies) of that aggregation unit and may not transmit or otherwise share information relating to those trading objectives or strategies to the member's or member firm's other aggregation units. The member or member firm may have risk management personnel outside of the RMM aggregation units view the positions of the multiple RMMs within the entity and direct position adjustments for risk management purposes. However, such persons may not transmit information to traders in an RMM aggregation unit about the trading strategies, objectives, or positions of another RMM aggregation unit.

Senior risk management personnel are prohibited from engaging in any of the following activities with respect to the Aggregation Units for which they oversee: (i) establishing quoting parameters for any trader including but not limited to delta and volatility values; (ii) directing the submission of specific quotes by any trader; or (iii) directing the timing of a trader's trading activities with anything other than general, nonspecific timeframes. Prior to being approved in an RMM capacity, each member or member organization operating multiple Aggregation Units would be required to certify that it is aware of these prohibitions, that it would comply with these prohibitions, and

that it would ensure continued compliance with these prohibitions.

(C) Individual traders are assigned to only one aggregation unit at any time; and

(D) The member or member firm as part of its compliance and/or internal audit routines establishes and maintains surveillance and audit procedures that facilitate the review and surveillance programs of the firm and CBOE to ensure the independent operation of the separate aggregation units operating as RMMs. As part of these routines, the member or member firm must retain written records of information concerning the aggregation units, including, but not limited to, trading personnel, names of personnel making trading decisions, unusual trading activities, disciplinary action resulting from a breach of the member or member firm's systems firewalls and information-sharing policies, and the transfer of securities between the members or member firm's aggregation units, which information would be promptly made available to the Exchange upon its request. The member or member firm must promptly provide to the Exchange a written report at such time there is any material change with respect to the aggregation units, at which point the Exchange would reexamine its status.

Proposed paragraph (d) governs the RMM appointment process and provides that an RMM may choose either a Physical Trading Crowd ("PTC") or Virtual Trading Crowd ("VTC") appointment, as described below. The proposed rule change, as amended, includes a restriction to prevent members from using a membership for multiple purposes. In this respect, proposed CBOE Rule 8.4(d) provides that memberships used to satisfy membership requirements to possess an RMM PTC or VTC appointment may not be used for any other purpose while being used in an RMM capacity, including being leased to another member or for trading on the

trading floor.<sup>11</sup>

A PTC Appointment would correspond to the location of a physical trading station on the floor of the CBOE. An RMM that chooses a PTC appointment would have the right to quote electronically (and not in open outcry): 30 Hybrid 2.0 Platform (“Hybrid 2.0” or “Hybrid 2.0 Platform”) products traded in that specific trading station for each Exchange membership it owns;<sup>12</sup> or 20 Hybrid 2.0 products traded in that specific trading station for each Exchange membership it leases.<sup>13</sup>

As proposed, a VTC Appointment confers the right to quote electronically (and not in open outcry) an appropriate number of products selected from “tiers” that have been structured according to trading volume statistics. By being able to choose the products it wishes to trade, an RMM would have unparalleled flexibility in choosing and structuring its appointment. As proposed, RMMs would be able to choose from all products included in the Hybrid 2.0 Platform. Of those products, Tier A would consist of the 20% most actively-traded products over the preceding three calendar months, Tier B the next 20%, etc., through Tier E, which would consist of the 20% least actively-traded products. All products within a specific Tier would be assigned an “appointment cost” depending upon its Tier location. Each Tier A product would have an “appointment cost” of .10, each Tier B product would be .0667, each Tier C product would be .05, each Tier D product would be .04, and each Tier E product would be .033. An RMM as part of its VTC appointment may select for each membership it owns or leases any combination of

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<sup>11</sup> An Exchange membership includes a transferable regular membership or a Chicago Board of Trade full membership that has effectively been exercised pursuant to Article Fifth(b) of the Certificate of Incorporation.

<sup>12</sup> The Exchange proposes in CBOE Rule 1.1(aaa) definitions for Hybrid Trading System and Hybrid 2.0 Platform.

<sup>13</sup> For purposes of this rule, the term “product” refers to all options of the same single underlying security/value.

Hybrid 2.0 products whose aggregate “appointment cost” does not exceed 1.0. For example, an RMM could request six “A Tier” products (6x.10), four “C Tier” products (4x.05), and five “D Tier” products (5x.04) to constitute its VTC appointment.

The Exchange would rebalance the “tiers” once each calendar quarter, which may result in additions or deletions to their composition. When a product changes “tiers” it would be assigned the “appointment cost” of that tier. Upon rebalancing, each RMM with a VTC appointment would be required to own or lease the appropriate number of Exchange memberships reflecting the revised “appointment costs” of the products constituting its appointment. Proposed paragraph (d) also provides that an RMM may only change its appointment upon providing advance notification to the Exchange in a form and manner prescribed by the Exchange.

Proposed paragraph (e) provides that the Exchange may suspend or terminate any appointment of an RMM in one or more classes under this rule whenever, in the Exchange’s judgment, the interests of a fair and orderly market are best served by such action. This is similar to ISE Rule 802 and CBOE Rule 8.3. An RMM may seek review of any action taken by the Exchange pursuant to CBOE Rule 8.4 in accordance with Chapter XIX of the CBOE Rules.

Proposed CBOE Rule 8.4(f) provides that RMMs are subject to CBOE Rule 8.7.03A with respect to trading in appointed classes.<sup>14</sup> RMMs may not enter quotations in option classes that are not included within their appointments although they may submit orders in non-appointed classes.

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<sup>14</sup> CBOE Rule 8.7.03A requires at least 75% of a Market-Maker’s total contract volume (measured quarterly) be in his/her appointed classes.

## **CBOE Rule 8.3A Maximum Number of Market Participants Quoting Electronically per Product**

The Exchange does not have unlimited systems bandwidth capacity to support an unlimited number of electronic quoters in every class. For this reason, the Exchange proposes to limit the number of members quoting electronically in each product (“Class Quoting Limit” or “CQL”) traded on Hybrid or Hybrid 2.0.<sup>15</sup> By limiting the number of quoters in all Hybrid and Hybrid 2.0 classes/products, the Exchange ensures it would have the ability to effectively handle all quotes generated by members. The number of members permitted to quote in each product is specified in proposed CBOE Rule 8.3A.01. The methodology for determining which members would be able to quote electronically in a product is governed by proposed CBOE Rule 8.3A(a)-(c).

When a CQL is established for each product, the following criteria govern which members are entitled to quote electronically in that subject product. A Market-Maker (excluding an RMM and e-DPM) that is not eligible to quote electronically in a product still may quote in open outcry in that product.

### **Products Trading on the Hybrid 2.0 Platform as of January 6, 2005 and Products Trading on the Hybrid Trading System as of January 6, 2005**

The DPM and e-DPMs (if applicable<sup>16</sup>) assigned to the product on January 6, 2005, and MMs who: (1) are in good standing with the Exchange; and (2) (i) have transacted at least 80% of their Market-Maker contracts and transactions in-person in each of the three immediately preceding calendar months prior to January 6, 2005 in option products traded in the trading

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<sup>15</sup> For purposes of this rule, the term “product” refers to all options of the same single underlying security/value.

<sup>16</sup> Non-Hybrid 2.0 classes do not have e-DPMs.

station; or (ii) were physically present in the trading station acting in the capacity of a MM on January 6, 2005, would be entitled to quote electronically in those products for as long as they maintain an appointment those products.<sup>17</sup>

All other MMs, RMMs, and approved e-DPMs that request the ability to submit quotes electronically in the subject product would be entitled to quote electronically in that product in the order in which they so request provided the number of members quoting electronically in the product does not exceed the CQL. When the number of members in the product quoting electronically equals the CQL, all other members requesting the ability to quote electronically in that product would be wait-listed in the order in which they submitted the request.

The waiting list would operate based on time priority. When the product can accommodate another electronic quoter (whether due to attrition or an increase in the CQL), the member at the “top” of the list (i.e., the member that has been on the waiting list the longest amount of time) would have priority. Once a member is wait-listed, the Exchange may not alter his/her position on the wait-list other than to improve such position (i.e., the Exchange may not place other members ahead of a previously wait-listed member). If a wait-listed member is offered, yet refuses, the ability to quote electronically in the subject product, the member would be removed from that waiting list.

### **Products Added to the Hybrid 2.0 Platform After January 6, 2005**

With respect to a product that is added to the Hybrid 2.0 Platform after January 6, 2005, the DPM and e-DPMs appointed to the product would be entitled to quote electronically. All

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<sup>17</sup> CBOE represents that the practical effect of this rule is to ensure that the DPM, all MMs, and all e-DPMs would be guaranteed the ability to quote electronically in products trading at their primary trading stations as of January 6, 2005. CBOE further represents that there were no products as of this date for which the number of members quoting electronically exceeded the CQL for that product.

MMs quoting in the product prior to its addition to the Hybrid 2.0 Platform would be entitled to quote electronically provided that: (i) they have transacted at least 80% of their MM contracts and transactions in-person in each of the three immediately preceding calendar months prior to the product being added to the Hybrid 2.0 Platform in option products traded in the trading station; or (ii) they were physically present in the trading station acting in the capacity of a MM on the day prior to the product being added to the Hybrid 2.0 Platform. These standards, which also are contained in paragraph (a) of this rule, would ensure that MMs that maintained a presence in the class prior to its conversion to the Hybrid 2.0 Platform would be guaranteed the ability to quote electronically upon conversion to Hybrid 2.0. If at the time a product is added to the Hybrid 2.0 Platform the aggregate number of DPMs, e-DPMs, and MMs entitled to quote electronically in the product exceeds the CQL, then the product would have an “increased CQL,” as described in proposed Interpretations and Policies .01(a). Reduction of any “increased CQL” would be in accordance with the procedures described in proposed Interpretations and Policies .01(a).

All other members would be entitled to quote electronically in that product in the order in which they so request provided the number of members quoting electronically in the product does not exceed the CQL. When the number of members quoting electronically in the product equals the CQL, all other members would be wait-listed in the order in which they request the ability to quote electronically. The wait-list would operate as described in proposed CBOE Rule 8.3A(a).

#### **Products Added to the Hybrid Trading System After January 6, 2005**

With respect to a new product that commences trading on the Hybrid Trading System after January 6, 2005, the assigned DPM would be entitled to quote electronically. Thereafter,

all other members would be entitled to quote electronically in that product in the order in which they so request provided the number of members quoting electronically does not exceed the CQL. When the number of members quoting electronically in the product equals the CQL, all other members would be wait-listed in the order in which they request the ability to quote electronically. The wait-list would operate as described in proposed CBOE Rule 8.3A(a).

### **Establishing the Class Quoting Limits (Proposed Interpretations and Policies .01)**

There would not be a uniform CQL for each class traded on the Exchange, rather the CQL would vary by product. The section below describes the process for affixing CQLs for all products.

### **Products Trading on the Exchange as of January 6, 2005:**

CBOE proposes that the CQL for all products trading on the Hybrid Trading System would be twenty-five (25). The twenty-sixth member to request the ability to quote electronically in a Hybrid class would be first on the wait list for that product.

The CQLs for products trading on the Hybrid 2.0 Platform would vary based on trading volume over the preceding calendar quarter. CBOE proposes that the CQL would be as follows: 40 for the 20% most actively-traded products over the preceding quarter; 35 for the next 20% most actively-traded products; 30 for the next 20% most actively-traded products; and 25 for all other Hybrid 2.0 Platform products.<sup>18</sup> The Exchange has selected these levels because they strike the optimum balance between the Exchange's need to not exceed its internal quote capacity by allowing an unlimited number of quoters in every class and the need to provide greater liquidity in the more actively-traded classes.

At the end of each calendar quarter, products would be assigned a different CQL based

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<sup>18</sup> See proposed CBOE Rule 8.3A.01.

on the revised trading volume statistics (“new CQL”). For example, if a product with 25 electronic quoters now qualifies (based on increased trading volume) for 35 electronic quoters, the CQL increases immediately and those on the wait-list would be added (if applicable). Otherwise, time priority governs who would be entitled to quote electronically in that class.

If the number of members quoting electronically in the product on the last day of the quarter equals or is less than the new CQL, then the previous CQL would be reduced immediately to the new CQL.<sup>19</sup> If the number of members quoting electronically in the product on the last day of the quarter is greater than the new CQL, then that product would have an “increased” CQL. CBOE represents that the reason for the “increased” CQL is to avoid having to prevent members from quoting electronically in a product in which they are already quoting. In this regard, the “increased” CQL would equal the number of members quoting electronically in the product on the last day of the quarter. If a member changes his/her appointment and ceases quoting electronically in that product, the “increased” CQL would decrease by one until such time that the number of remaining members quoting electronically in the product equals the new CQL.<sup>20</sup> From that point forward, the number of members quoting electronically in the product may not exceed the new CQL.

As an example, assume product ABC’s existing CQL is 40, the new CQL on rebalancing date should be 30, and that 33 members are quoting electronically in the product on the last day of the quarter. Rather than prevent three members from quoting, the CQL would be increased to 33. If one of those 33 members “drops” the product from his/her appointment and thus no longer quotes electronically, the “increased” CQL would drop to 32. When two others leave, the CQL

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<sup>19</sup> See proposed CBOE Rule 8.3A.01(i).

<sup>20</sup> See proposed CBOE Rule 8.3A.01(ii).

would become 30 and the first member on the wait list would be entitled to quote electronically when one other member leaves the product.

**Products Not Traded on the Exchange as of January 6, 2005:**

The CQL for all products newly-listed on the Exchange after January 6, 2005 would be 25 until such time that the CQL increases in accordance with this proposed Interpretations and Policies .01. In this regard, when the product's trading volume increases such that the product then qualifies for a higher CQL, it would receive a higher CQL.

**Increasing the Class Quoting Limit in Exceptional Circumstances**

CBOE believes that having an established upper limit on the number of members that may quote electronically in any given product works effectively for the overwhelming vast majority of products traded on CBOE. Nevertheless, there are bound to be instances in which the demand to quote in a new or existing product greatly exceeds the CQL for that product. For example, more than 150 members trade options on the S&P 500 ("SPX") index. If the Exchange were to trade SPX options on Hybrid, a CQL of 25 would be low. It is for these rare instances that the Exchange proposes to adopt a rule to allow for a higher CQL.

In this regard, when exceptional circumstances warrant, the President of the Exchange (or in his absence his designee, who must be a Senior Vice President of the Exchange or higher) may increase the CQL for an existing or new product. "Exceptional circumstances" refers to substantial trading volume, whether actual or expected (e.g., in the case of a new product or a major news announcement). The Exchange does not intend for this discretion (i.e., to increase the CQL) to be exercised on an intra-day basis. Rather, the primary instance for which the Exchange anticipates this discretion being exercised is for the addition of new products to Hybrid or Hybrid 2.0 for where the standard CQL is not high enough to accommodate the anticipated

trading volume and member demand. When the CQL increases pursuant to the President exercising his authority in accordance with this paragraph, members on the wait-list (if applicable, with respect to a product already trading on Hybrid), would have first priority and remaining capacity would be filled on a time priority basis.<sup>21</sup>

Upon cessation of the exceptional circumstances, the President (or his designee), in his discretion, may determine to reduce the CQL. Any reduction in the CQL must be undertaken in accordance with the procedure established in paragraph .01(a)(ii) above with respect to lowering the “increased CQL.” This means that if the new CQL is less than the number of members quoting electronically in that product, there would be an “increased” CQL. Any actions taken by the President of the Exchange pursuant to this paragraph (to increase or decrease the CQL) would be submitted to the SEC in a rule filing pursuant to Section 19(b)(3)(A) of the Act.

The Exchange would announce all changes regarding CQLs to the membership via Information Circular. The Exchange may increase the CQL levels established in paragraphs .01(a) and (b) by submitting to the SEC a rule filing pursuant to Section 19(b)(3)(A) of the Act. The Exchange may decrease the CQL levels established above upon SEC approval of a rule filing submitted pursuant to Section 19(b)(2) of the Act.

#### **CBOE Rule 8.7      Obligations of Market-Makers**

The Exchange proposes to amend CBOE Rule 8.7 to clarify the obligations applicable to RMMs. As RMMs would not be able to quote in open outcry, the Exchange proposes to amend paragraph (b)(iii) to specify the permissible methods by which in-crowd market makers and RMMs may quote or submit orders.

The Exchange also proposes to amend paragraph (d), Market Making Obligations

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<sup>21</sup> For new products, proposed CBOE Rule 8.3A(a)-(c) governs.

Applicable in Hybrid Classes, to exclude RMMs from the application of this paragraph. RMMs instead would be subject to the obligations contained in new paragraph (e), which are based on the Hybrid obligations in CBOE Rule 8.7(d). Subparagraph (e)(i) states that RMMs must provide continuous two-sided, 10-up, legal-width quotations in 60% of the series of their appointed classes.<sup>22</sup> The Exchange may consider exceptions to this quoting requirement based on demonstrated legal or regulatory requirements or other mitigating circumstances (e.g., excused leaves of absence, personal emergencies, or equipment problems).<sup>23</sup>

Proposed subparagraph (ii) states that an RMM may be called upon by an Exchange official designated by the Board of Directors to submit a single quote or maintain continuous quotes in one or more series of an issue to which the RMM is appointed whenever, in the judgment of such official, it is necessary to do so in the interest of maintaining a fair and orderly market.<sup>24</sup>

Proposed subparagraph (iii) provides that all Exchange rules applicable to market makers would also apply to RMMs unless otherwise provided or unless the context clearly indicates otherwise. RMMs are not considered trading crowd members except as provided in CBOE Rules 6.13 and 8.60.<sup>25</sup>

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<sup>22</sup> If the underlying primary market disseminates a 100-share quote, an RMM's undecremented quote may be for as low as 1-contract ("1-up"), however, this ability is expressly conditioned on the process being automated (i.e., an RMM may not manually adjust its 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. RMMs that have not automated this process may not avail themselves of the relief provided herein. The ability to quote 1-up would operate on a pilot basis and would terminate on August 17, 2005, which is the same expiration date contained in CBOE Rules 8.7(d)(i)(B) and (d)(ii)(B) for Hybrid trading.

<sup>23</sup> This is virtually identical to PCX Rule 6.37(h)(3).

<sup>24</sup> This is virtually identical to PCX Rule 6.37(h)(4).

<sup>25</sup> This is based on PCX Rule 6.37(h)(1) and (2).

Proposed subparagraph (iv) provides that the evaluation of RMM performance would be pursuant to proposed CBOE Rule 8.61. Subparagraph (v) states that failure by an RMM to engage in a course of dealings as specified above would subject the RMM to disciplinary action or suspension or revocation of registration by the Exchange in one or more of the option classes in which the RMM holds an appointment.<sup>26</sup> Finally, proposed subparagraph (vi) requires RMMs to maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the RMM or that may act as specialist or market maker in any security underlying options allocated to the RMM, and otherwise comply with the requirements of CBOE Rule 4.18 regarding the misuse of material non-public information.

The Exchange also proposes to amend CBOE Rule 8.7.03B regarding a MM's in-person trading percentage requirements to clarify that it has no application to RMMs (as RMMs cannot quote in person). Finally, the Exchange proposes to make CBOE Rule 8.7.09 applicable to RMMs.

#### **CBOE Rule 8.8      Restrictions on Acting as Market-Maker and Floor Broker**

The Exchange proposes to amend CBOE Rule 8.8 to eliminate the requirement that an appointment must at least include all of the classes of options traded at one station. As RMMs may customize their appointments, this requirement has no applicability.

#### **CBOE Rule 8.61      Evaluation of RMMs**

Proposed CBOE Rule 8.61 provides that the appropriate Market Performance Committee ("MPC") would periodically conduct an evaluation of RMMs to determine whether they have fulfilled performance standards relating to, among other things, quality of markets, competition

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<sup>26</sup> This is virtually identical to PCX Rule 6.37(h)(6).

among market makers, observance of ethical standards, and administrative factors. The appropriate MPC may consider any relevant information including, but not limited to, the results of an RMM evaluation, trading data, an RMM's regulatory history and such other factors and data as may be pertinent in the circumstances.

Proposed paragraph (b) provides that the Exchange may terminate, place conditions upon, or otherwise limit a member's approval to act as an RMM on the same basis that market maker privileges may be terminated and/or conditioned under CBOE Rule 8.60. If a member's approval to act as an RMM is terminated, conditioned, or otherwise limited by the Exchange, the member may seek review of that decision under Chapter XIX of the CBOE Rules.

#### **CBOE Rule 6.45A Priority and Allocation of Trades for CBOE Hybrid System**

The Exchange proposes to amend certain portions of CBOE Rule 6.45A regarding allocation of trades on Hybrid. The first change is to expand the introductory paragraph definition of "market participant" to include RMMs. The second proposed change is to clarify in Paragraph (a), Allocation of Incoming Electronic Orders, that market participants may enter quotes or orders and receive allocations pursuant to the Ultimate Matching Algorithm.

The third proposed change is to amend paragraph (b), Allocation of Orders Represented in Open Outcry, to clarify that only in-crowd market participants would be eligible to participate in open outcry trade allocations. This is consistent with the prohibitions in CBOE Rules 8.4 and 8.7 that prevent an RMM from trading in open outcry. The Exchange also proposes to limit the duration of paragraph (b) to six months from the date of approval of this proposal, unless otherwise extended.

#### **CBOE Rule 6.73 Responsibilities of Floor Brokers**

The Exchange proposes to amend CBOE Rule 6.73(d) to require a Floor Broker holding

an order for the account of a Market-Maker or Specialist to verbally identify the order as such in open outcry prior to requesting a quote.

### **Changes to CBOE Membership Rules (3.2, 3.3, and 3.8)**

CBOE proposes to amend CBOE Rule 3.2 to make clear that a member is deemed to have an authorized trading function if the member is approved to act as a nominee or person registered for an RMM organization. This would ensure under CBOE Rule 3.9(g) that the RMM nominee completes CBOE's Member Orientation Program and passes CBOE's Trading Member Qualification Exam. The proposed amendments to CBOE Rules 3.2 and 3.3 would also clarify that a member may elect membership status as an RMM.

CBOE also proposes to amend CBOE Rule 3.8(a)(ii), which currently states that "if the member organization is the owner or lessee of more than one such membership, the organization must designate a different individual to be the nominee for each of the memberships (except that this subparagraph would not apply to memberships designated for use in an e-DPM capacity pursuant to CBOE Rule 8.92 by a member organization approved as an e-DPM)." New proposed CBOE Rule 3.8.02 would provide two exceptions to CBOE Rule 3.8(a)(ii) to accommodate the creation of RMMs. First, CBOE proposes to exclude RMMs from the CBOE Rule 3.8(a)(ii) requirement in the same manner as e-DPMs are excluded. As with e-DPMs, the CBOE Rule 3.8(a)(ii) requirement serves no useful purpose in the context of electronic access and market-making and may negatively affect an RMM member organization's operating structure by imposing upon it unnecessary expenses. To this end, CBOE proposes to restrict application of this rule such that it would not apply to memberships used in an RMM and e-DPM capacity. This would allow a member organization to designate one individual to be the nominee of the memberships that are designated for use in an RMM capacity and an e-DPM capacity,

provided that a member organization may not have more than one RMM appointment in an option class (except to the extent provided in CBOE Rule 8.4(c)) and may not have an RMM appointment in an option class in which the organization serves as a DPM, e-DPM, or Market-Maker on the Exchange (except to the extent provided in CBOE Rule 8.4(c)).

New proposed CBOE Rule 3.8.02(ii) would also provide a second exception to CBOE Rule 3.8(a)(ii) to permit an individual to act as a nominee of an organization with respect to one membership utilized in an RMM capacity and a membership not utilized in an RMM or e-DPM capacity in order to allow the nominee to use those memberships to simultaneously trade as an in-crowd Market-Maker and in an RMM capacity (but not in the same classes), provided that the RMM trading activity of the nominee is from a location other than the physical trading station for any of the classes traded by the nominee in an RMM capacity. CBOE represents that the purpose of this exception is to accommodate members who choose to take advantage of his or her remote market making privileges while on the Exchange floor.

## 2. Statutory Basis

The Exchange believes that the adoption of rules allowing for remote market making would attract and encourage member firms to provide supplemental liquidity to that currently provided on the floor by in-crowd market participants. Accordingly, the Exchange believes that the addition of RMMs would provide investors with deeper and more liquid markets. For these reasons, the Exchange believes the proposed rule change, as amended, 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>27</sup> Specifically, the Exchange believes the

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<sup>27</sup> 15 U.S.C. 78f(b).

proposed rule change, as amended, is consistent with the Section 6(b)(5)<sup>28</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 Exchange 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 comments on the proposal.

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 Exchange 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, 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

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<sup>28</sup> 15 U.S.C. 78f(b)(5).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-75 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-2004-75. 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-2004-75 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>29</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>29</sup> 17 CFR 200.30-3(a)(12).