

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51429; File No. SR-CBOE-2004-58)

March 24, 2005

Self-Regulatory Organizations; Order Granting Accelerated Approval to a Proposed Rule Change and Amendments No. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 3 and 4 to the Proposed Rule Change by the Chicago Board Options Exchange, Incorporated Relating to Market-Maker Quoting Obligations and Market-Maker Appointments

I. Introduction

On August 19, 2004, the Chicago Board Options Exchange, Incorporated (“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”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend existing CBOE rules and to adopt new rules governing quoting by CBOE Market-Makers (“Market-Makers” or “MMs”). On February 2, 2005, CBOE filed Amendment No. 1 to the proposed rule change.³ On February 17, 2005, CBOE filed Amendment No. 2 to the proposed rule change.⁴ The proposed rule change and Amendments No. 1 and 2 were published for comment in the Federal Register on March 1, 2005.⁵ The Commission received no comments on the proposal. On March 18, 2005, CBOE filed Amendment

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superceded CBOE’s original 19b-4 filing in its entirety.

⁴ Amendment No. 2 replaced and superceded CBOE’s original 19b-4 filing and Amendment No. 1 in their entirety.

⁵ See Securities Exchange Act Release No. 51234 (February 22, 2005), 70 FR 10006 (“Notice”).

No. 3 to the proposed rule change.⁶ On March 23, 2005, CBOE filed Amendment No. 4 to the proposed rule change.⁷ This order approves the proposed rule change and Amendments No. 1 and 2 on an accelerated basis, and publishes notice of and grants accelerated approval to Amendments No. 3 and 4 thereto.

II. Discussion

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. On July 12, 2004, the Commission approved a CBOE proposal to add a new category of market participant called "e-DPMs," who function as remote competing specialists in their allocated securities. By contrast, regular Designated Primary Market-Makers ("DPMs") and MMs

⁶ In Amendment No. 3, CBOE proposes to (1) amend the reference date contained in CBOE Rule 8.3A from January 6 to March 18, 2005, (2) adopt on a one-year pilot basis that portion of proposed CBOE Rule 8.3(c) governing a MM's ability to quote from a location outside of his/her trading station, (3) adopt procedures governing "temporary appointments" during the rollout of its Initial Remote Market-Market ("RMM") Appointment Process ("IRAP"), and (4) incorporate changes to the rule language as a result of the approval of a corresponding CBOE rule filing relating to RMMs. See Securities Exchange Act Release No. 51366 (March 14, 2005), 70 FR 13217 (March 18, 2005) (order approving "RMM filing"). The text of Amendment No. 3 is available on CBOE's Web site (<http://www.cboe.com>), at the CBOE's Office of the Secretary, and at the Commission's Public Reference Room.

⁷ In Amendment No. 4, CBOE proposes to amend CBOE Rule 8.3(c) to codify that any MM affiliated with an RMM would be prohibited from submitting electronic quotations from outside of its appointed trading station in any class in which the affiliated RMM has an appointment. This prohibition was specifically published for comment in the Notice. See Notice, supra note 5, at footnote 13 ("...See also proposed CBOE Rule 8.4(c)(i) in the Exchange's proposed RMM filing. The same prohibition would apply to MMs affiliated with RMMs and is contingent upon SEC approval of the Exchange's RMM filing..."). The text of Amendment No. 4 is available on CBOE's Web site (<http://www.cboe.com>), at the CBOE's Office of the Secretary, and at the Commission's Public Reference Room.

on CBOE are required to operate from within their appointed trading station.⁸ Under the current proposal, CBOE proposes to grant its MMs the ability to stream quotes from locations other than their appointed trading stations.⁹ Accordingly, CBOE proposes to amend its rules governing the MM appointment process (CBOE Rule 8.3) and MM quoting obligations (CBOE Rule 8.7).

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange¹⁰ and, in particular, the requirements of Section 6 of the Act¹¹ and the rules and regulations thereunder. The Commission specifically finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act¹² 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.

⁸ The current Hybrid rules allow MMs on CBOE to stream electronic quotes only when they are physically present in their appointed trading stations.

⁹ For example, rather than “calling in sick” to work and thereby relinquishing the ability to quote altogether, a MM would be able to stream quotes from his/her home office. This proposal, as amended, only allows current MMs to quote remotely (i.e., from outside of their appointed trading stations) on a one-year pilot basis. See proposed CBOE Rule 8.3(c). See also CBOE Rule 8.4 and RMM filing for rules governing Remote Market-Makers.

¹⁰ In approving this proposed rule change, as amended, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹¹ 15 U.S.C. 78f.

¹² 15 U.S.C. 78f(b)(5).

A. Market-Maker Appointments

Currently, a MM's appointment consists of all classes traded at a particular trading station, regardless of the number of classes actually trading at that station and regardless of whether the MM owns or leases a membership. In addition, CBOE Rule 8.3(c) currently provides that MMs may have appointments in up to ten trading stations on the floor. The Exchange proposes to amend these requirements in several respects.

As proposed, a MM's appointment would confer the right to quote in open outcry all classes traded on the Exchange, regardless of the trading station at which they are located.¹³ A MM's appointment would also confer the right to quote electronically in all Hybrid classes traded on the Hybrid Trading System that are located in one designated/appointed trading station, and, with respect to Hybrid 2.0 Classes (as defined in CBOE Rule 1.1(aaa)), the ability to submit electronic quotations in up to 40 classes for each Exchange membership it owns or up to 30 classes for each Exchange membership it leases, all of which must be located in the MM's one appointed trading station.¹⁴

However, a MM affiliated with an e-DPM or an RMM would be prohibited from submitting electronic quotations from outside of its appointed trading station in any class in which the affiliated e-DPM or affiliated RMM has an appointment.¹⁵

¹³ For margin purposes, these transactions would qualify as MM transactions.

¹⁴ If a trading station consists of fewer than 40 (30) Hybrid 2.0 Classes, each MM that owns (leases) a membership would be eligible to submit electronic quotations in each of the Hybrid 2.0 Classes at that trading station, in accordance with the requirements of CBOE Rule 8.3A. In addition, Amendment No. 3 places MMs ability to quote electronically in his/her appointed Hybrid and Hybrid 2.0 classes from a location outside of his/her appointed trading station on a one-year pilot. See proposed CBOE Rule 8.3(c).

¹⁵ See CBOE Rules 8.93(vii) and 8.4(c)(ii). See also Amendment No. 4.

Under the proposal, a MM that trades in open outcry away from his/her appointed trading station would be restricted to open outcry trading only for classes at that trading station and would not be eligible to quote electronically in those classes until such time that the MM notifies the Exchange of his/her request to change his/her appointment and such request is approved in accordance with CBOE's rules. On any day a MM trades in open outcry outside of his/her appointed trading station, that MM may be required to undertake market-making obligations in those classes in which the MM trades in open outcry at the request of the Order Book Official.¹⁶

The proposal limits a MM's appointments to the classes located at one trading station. In Hybrid, MMs currently may only stream quotes where they are physically present in the trading crowd, which in essence already creates a "one trading station" appointment.¹⁷ As is the case today, MMs would continue to be able to leave one trading station and trade in another trading station; however, they would be required to notify the Exchange prior to switching trading stations and request an appointment in the classes located at a new trading station, which would be granted on a space-available basis (as described in more detail in CBOE Rule 8.3A). A MM's ability to trade in non-appointed classes would be limited to submitting orders for automatic execution pursuant to CBOE Rules 6.8 or 6.13.¹⁸

¹⁶ See CBOE Rule 8.7(c), discussed infra.

¹⁷ The Exchange represents that it is gradually transferring all equity classes to the Hybrid Trading System and anticipates having all such classes on Hybrid within the first quarter of 2005.

¹⁸ As part of its appointment, a MM may trade in open outcry all classes located on the Exchange. See proposed CBOE Rule 8.7(b)(iii) for the permissible methods by which MMs may submit quotes and orders in appointed and non-appointed classes. CBOE Rule 6.8 applies to non-Hybrid classes, while CBOE Rule 6.13 applies to Hybrid classes.

Proposed CBOE Rule 8.3(c) provides that a MM would be presumed to have an appointment in all non-Hybrid 2.0 classes located at his/her appointed trading station unless the MM specifically indicates to the Exchange that he/she does not want to include a particular class(es) as part of his/her appointment (“excluded classes”).¹⁹ When a MM excludes a class, the Exchange would be able to provide an appointment in that excluded class to a MM that does not currently trade that class but who has an interest in doing so. A MM is not eligible to submit electronic quotations into any class it designates as an excluded class. Any request by a MM to receive a subsequent appointment in a previously excluded class would be handled in accordance with CBOE Rule 8.3A.

The Commission believes that the proposed amendments to CBOE Rule 8.3 to allow MMs the ability to stream quotes electronically from remote locations outside of a MM’s appointed trading station are consistent with the Act.

B. Market-Maker Quoting Obligations

The Exchange proposes several changes to CBOE Rule 8.7 to accommodate MMs quoting from outside of their appointed trading stations. The Exchange proposes to revise CBOE Rule 8.7(b)(i) to obligate MMs to compete with other MMs to improve markets in all series of options classes comprising the MM’s appointment, whether trading electronically or in person. In addition, the Exchange proposes to amend CBOE Rule 8.7(b)(iii) in two primary respects. The first change proposes to obligate a MM to update quotes in his/her appointed classes at the trading station where the MM quotes, whether in person or electronically. The second change is designed to clarify the

¹⁹ Because MMs must specifically designate which Hybrid 2.0 Classes they would trade as part of their appointment, there is no need to have them designate which Hybrid 2.0 Classes they would not trade.

permissible methods by which a MM may submit quotes and orders in both appointed and non-appointed classes. Specifically, proposed CBOE Rule 8.7(b)(iii)(A) provides that, with respect to trading in appointed classes: (1) MMs who are physically present in their appointed trading station may enter quotes and orders in their appointed classes by public outcry in response to a request for a quote or, in classes in which Hybrid or Hybrid 2.0 is implemented, through an Exchange-approved electronic interface via an Exchange-approved quote generation device; (2) MMs may also enter quotes and orders in their appointed Hybrid and Hybrid 2.0 classes from outside of their appointed trading stations (pursuant to CBOE Rule 8.3) through an Exchange-approved electronic interface via an Exchange-approved quote generation device; and (3) MMs, whether physically present in their appointed trading stations or not, may also submit orders for automatic execution in accordance with the requirements of CBOE Rules 6.8 or 6.13. Proposed CBOE Rule 8.7(b)(iii)(B) provides that, with respect to trading in non-appointed classes, MMs may submit orders for automatic execution in accordance with the requirements of CBOE Rules 6.8 or 6.13.²⁰

The Exchange also proposes changes to CBOE Rule 8.7(c) to ensure that a MM who trades in classes located outside of his appointed trading station would be required to fulfill all obligations imposed by CBOE Rule 8.7(b) and, for the rest of the trading day, the MM may be called back to that station to make markets in open outcry in the classes in which he/she traded.

Current CBOE Rule 8.7(d) governs market-making obligations in Hybrid classes. Generally, the extent of a MM's obligations is dictated by the amount of volume a MM

²⁰ In this regard, CBOE Rule 8.3 also would prohibit a MM from quoting electronically into a non-appointed class.

transacts electronically. The Exchange intends to retain CBOE Rule 8.7(d)(i)²¹ and to amend CBOE Rule 8.7(d)(ii). As amended, MMs that transact more than 20% of their volume electronically would be obligated to comply with the bid-ask width requirements of CBOE Rule 8.7(b)(iv),²² maintain continuous quotes for at least ten contracts in 60% of the series of his/her appointed classes,²³ and respond to all open outcry requests for quotes with a ten-up, legal width market.²⁴ Proposed for elimination is the tiered continuous quoting requirement that is dependent upon the amount of volume transacted electronically on the Exchange. CBOE believes an across-the-board 60% quoting requirement is simpler and more effective.

The Exchange also proposes changes to Interpretations and Policies .03 to CBOE Rule 8.7. All MMs would still be required to comply with CBOE Rule 8.7.03(A), which requires 75% of a MM's volume to be in his/her appointed classes. The Exchange intends to retain the in-person requirement contained in current paragraph (B), but limit its application to non-Hybrid classes. Because MMs would have the ability to quote from outside of their appointed trading stations, CBOE believes that an in-person requirement no longer makes sense.²⁵ The Exchange further proposes changes to Interpretations and

²¹ CBOE Rule 8.7(d)(i) applies to MMs that transact less than 20% of their contract volume electronically.

²² Bid-ask width requirements are currently \$5 except during the opening rotation.

²³ A MM's undecremented quote must be for ten contracts unless the underlying market disseminates a 1-up market, in which case MMs who have automated the process may similarly quote 1-up. This "1-up" pilot program is scheduled to expire on August 17, 2005. See CBOE Rules 8.7(d)(i)(B) and (d)(ii)(B).

²⁴ Only MMs physically present in a trading station would have the ability to provide markets in open outcry.

²⁵ A MM's ability to quote electronically from outside of its appointed trading station is limited to appointed Hybrid and Hybrid 2.0 classes, as described and proposed in CBOE Rule 8.3(c).

Policies .09 to CBOE Rule 8.7 to clarify the applicability of the rule to a MM electronically quoting outside of his/her appointed trading station in accordance with proposed CBOE Rule 8.3(c).

The Commission believes that the proposed changes to MM quoting obligations are appropriate to accommodate MMs' ability to electronically stream quotes in their appointed Hybrid classes and appointed Hybrid 2.0 classes from outside of their appointed trading stations. As such, the Commission finds the changes to CBOE Rule 8.7 relating to MM obligations to be consistent with the Act.

C. Amendments No. 3 and 4 to the Proposed Rule Change

Amendment No. 3 to the proposed rule change (1) amends the reference date contained in CBOE Rule 8.3A, (2) adopts on a one-year pilot basis that portion of proposed CBOE Rule 8.3(c) governing a MM's ability to quote electronically from outside his/her appointed trading station, (3) adopts procedures governing "temporary appointments," and (4) incorporates changes to rule language as a result of the approval of CBOE's RMM filing.²⁶

1. Changing the Grandfather Date from January 6 to March 18, 2005

CBOE Rule 8.3A establishes procedures for determining the maximum number of market participants that may quote electronically in a given class. As part of those procedures, the Exchange has used a January 6, 2005 "grandfather" date for the purpose of determining who will be entitled to quote electronically. The Exchange proposes to amend this rule to substitute March 18, 2005, as the new "grandfather" date.²⁷ Using a

²⁶ See RMM filing, *supra* note 6.

²⁷ The practical effect of this rule is to ensure that the DPMs, all MMs, and all e-DPMs would be guaranteed the ability to quote electronically in products trading

later date allows the Exchange to ensure that members would be “grandfathered” into the crowds in which they are quoting as of a date that is more close to the actual rollout of its RMM program.²⁸

2. Adoption of CBOE Rule 8.3(c) on Pilot Basis

One of the proposed changes to CBOE Rule 8.3(c) would allow a MM to submit electronic quotations from a location outside of the appointed trading station in his/her appointed Hybrid classes and his/her appointed Hybrid 2.0 Classes. The Exchange proposes to further amend this aspect of the rule such that it is on a one-year pilot basis. As part of a pilot program, the Exchange would have the ability to evaluate this provision’s effectiveness. At the end of the one-year period, based upon the conclusions reached, the Exchange could propose to extend the pilot or request permanent approval, in which case it would need to submit a rule filing pursuant to Section 19 of the Act and receive Commission approval. Alternatively, the Exchange could determine to allow this provision to lapse, in which case MMs no longer would have the ability to quote from outside of their appointed trading stations.

3. “Temporary Appointments”

The Exchange proposes to adopt procedures governing the ability of MMs to change their appointed trading stations from the period between the “grandfather” date (described above) and the end of the IRAP. The IRAP is the process by which Exchange

at their primary trading stations as of March 18, 2005. CBOE represents that there were no products as of this date for which the number of members quoting electronically exceeded the Class Quoting Limit (“CQL”) for that product.

²⁸ The Exchange made a similar change in Amendment No. 2 to the RMM filing when it “pushed back” the previous “grandfather” date from December to January 6, 2005. See RMM filing, supra note 6, for a more detailed description of the RMM program.

will grant appointments to RMMs and it will work on a time priority basis. The Exchange expects the process to begin the week of April 18, 2005 and to be finalized by April 22, 2005.

In this regard, the purpose of these procedures is to enable the Exchange to know with certainty the number of electronic appointments that will be available in each product during the IRAP. If MMs that receive “grandfathered” appointments were able to change their trading stations, it would be extremely difficult for the Exchange to know with certainty how many electronic appointments were available on a per product basis. For this reason, the Exchange proposes that, for the limited period from March 21, 2005, through the end of the IRAP, MMs would be able to switch trading stations, albeit on a temporary basis, as described below.

Under proposed Interpretations and Policies .02 to CBOE Rule 8.3A (“Temporary Appointments” for the Period from March 21, 2005 through the end of the Initial RMM Appointment Process), the following procedures would apply to MMs’ requests to change their appointed trading stations during the period commencing March 21, 2005, and lasting until the end of the IRAP.

1. Beginning March 21, 2005, until the termination of the IRAP, all MM requests to change their appointed trading stations would be granted on a temporary basis (“temporary appointment”), provided the CQL for the requisite product has not been met (i.e., on a space-available basis, as described in Rule 8.3A.01). Each temporary appointment terminates at 3:15 p.m. (CT) on the last day of the IRAP, at which point all MMs’ appointed trading stations would revert to the appointed trading station the MM held on March 18, 2005.

2. In order to receive a permanent appointment in a product in which a MM previously held a temporary appointment, a MM must participate in the IRAP and be allocated such product.

3. Upon termination of the IRAP, all MM (including RMM) requests for appointments and/or appointed trading stations would be handled subject to the requirements of Rule 8.3A (Class Quoting Limits) and in accordance with the appointment procedures of Rules 8.3 (MM appointments) and 8.4 (RMM appointments), as applicable.

Amendment No. 4 to the proposed rule change proposes to amend CBOE Rule 8.3(c) to codify that any MM affiliated with an RMM would be prohibited from submitting electronic quotations from outside of its appointed trading station in any class in which the affiliated RMM has an appointment.²⁹

The Commission believes that the proposed changes in Amendment No. 3 are necessary and appropriate to allow the Exchange to commence its IRAP knowing exactly how many electronic quoting appointments would be available in each of the products included in the RMM program based on the number of grandfathered MM appointments in particular classes. This certainty would enable the appointment process to operate efficiently and expediently. In addition, the Commission believes that placing that portion of proposed CBOE Rule 8.3(c) governing MMs' ability to stream electronic quotes from locations outside of their appointed trading stations on a one-year pilot should allow the Exchange ample opportunity to evaluate the effectiveness such pilot. Furthermore, the Commission notes that the proposed amendment to CBOE Rule 8.3(c)

²⁹ See supra note 7.

in Amendment No. 4 simply incorporates into the proposed rule a prohibition against a MM affiliated with an RMM from streaming electronic quotes from outside of his/her appointed trading station into any class in which the affiliated RMM has an appointment.³⁰ As a result, the Commission finds that Amendments No. 3 and 4 are consistent with the Act.

D. Accelerated Approval of the Proposed Rule Change and Amendments No. 1, 2, 3 and 4

The Commission finds good cause for approving the proposed rule change and Amendments No. 1, 2, 3, and 4 thereto prior to the thirtieth day after the amendment is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.³¹ The Commission believes that accelerating approval of the proposal, as amended, is necessary to the proper operation of the CBOE's Hybrid Trading System and Hybrid 2.0 Platform because it would allow MMs to quote electronically from outside of their appointed trading stations at approximately the same time that CBOE begins the rollout of its RMM program, and would allow CBOE to commence its IRAP with a better understanding of how many electronic appointments would be available in products included in the RMM program. The Commission therefore believes that accelerated approval of the proposed rule change and Amendments No. 1, 2, 3, and 4 is appropriate, and finds that it is consistent with the Act.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendments No. 3 and 4 to the proposed

³⁰ The Commission notes that this prohibition was specifically published for comment in the Notice. See supra note 5.

³¹ 15 U.S.C. 78s(b)(2).

rule change are 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-2004-58 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-2004-58. 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-2004-58 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³² that the proposed rule change (SR-CBOE-2004-58), as amended, be approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³³

J. Lynn Taylor
Assistant Secretary

³² 15 U.S.C. 78s(b)(2).

³³ 17 CFR 200.30-3(a)(12).