

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51680; File No. SR-CBOE-2004-87)

May 10, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Trading Rules on the Hybrid System for Index Options and Options on ETFs

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 17, 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 March 23, 2005, the CBOE submitted Amendment No. 1 to the proposed rule change.³ On April 26, 2005, the CBOE submitted Amendment No. 2 to the proposed rule change.⁴ 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 Exchange proposes to adopt index hybrid trading rules applicable to classes in which there are Designated Primary Market-Makers ("DPMs"), Lead Market-Makers ("LMMs") or, alternatively, Market-Makers ("MMs"). Below is the text of the proposed rule change, as amended.

Proposed new language is in *italics*; proposed deletions are in [brackets].

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superseded the originally filed proposed rule change.

⁴ Amendment No. 2 replaced and superseded the originally filed proposed rule change and Amendment No. 1.

Rule 6.1 Days and Hours of Business

* * * * *

Interpretations and Policies

.01 - .03 No change.

.04 For those option classes and within such time periods as the appropriate Floor Procedure Committee, MTS or the President of the Exchange may designate, members may, prior to the scheduled opening rotation, enter option market quote indications based upon the anticipated opening price of the security underlying such designated option class. This interpretation will not impose upon members an affirmative responsibility to provide and post pre-opening option market quote indicators. Generally, pre-opening option market quote indications would be provided by members for options classes whose underlying security is sold over-the-counter and those option classes whose underlying security shows little market volatility.

The following procedures shall be followed by members and the Order Book Official, [or] DPM, or LMM when posting pre-opening option market quote indications.

(a) For those options classes designated as eligible for pre-opening option market quote indications the OBO, [or] DPM, or LMM shall, no earlier than 8:15 a.m. (CT), request market quote indications from the members present in the trading crowd.

(b) The members and DPM or LMM may then provide pre-opening option market quote indications at which time the OBO, [or] DPM, or LMM shall post these indications. Upon the opening of the underlying security and in no case earlier than 8:30 a.m. (CT) the OBO, [or] DPM, or LMM shall request verbal confirmation from the trading crowd that such pre-opening option market quote indications reflect the actual market and constitute valid opening quotations.

If the crowd indicates that such pre-opening option market quote indications reflect the actual

market and constitute valid opening quotations, the OBO, [or] DPM, or LMM shall determine that a simultaneous opening rotation has occurred. If they do not confirm the indications, an opening rotation in accordance with applicable Exchange Rules for all series in which floor brokers in the crowd or the Book hold executable limit or market orders will be held. After such orders have been executed, the OBO, [or] DPM, or LMM shall declare the option class open and the series subject to applicable Exchange Rules.

(c) Notwithstanding paragraphs (a) and (b), the OBO, [or] DPM, or LMM shall direct that an opening rotation take place pursuant to applicable exchange Rules if (i) the OBO, [or] DPM, or LMM fails to receive market quote indications; or (ii) the underlying security opens substantially higher or lower than the opening price anticipated by the crowd that provided the pre-opening market quote indications; or (iii) there are substantial order imbalances affecting the options class; or (iv) for such other reasons as appropriate Floor Officials, the OBO, the DPM, or LMM or the Exchange may determine.

* * * * *

Rule 6.2 Trading Rotations

* * * * *

Interpretations and Policies

.01 (a) Trading rotations shall be employed at the opening of the Exchange each business day. For each class of option contracts that has been approved for trading, the opening rotation shall be conducted by the [Board Broker,] Designated Primary Market-Maker ("DPM"), Lead Market-Maker ("LMM"), or Order Book Official ("OBO") acting in such class of options. The opening rotation in each class of options shall be held promptly following the opening of the underlying security on the principal market where it is traded or after 8:30 a.m. for index options. As a rule,

a [Board Broker,] DPM, LMM, or OBO acting in more than one class of options should open them in the same order in which the underlying securities are opened.

(b) In conducting each such opening rotation, the [Board Broker,] DPM, LMM, or OBO should ordinarily first open the one or more series of options of a given class having the nearest expiration, then proceed to the series of options having the next most distant expiration, and so forth, until all series have been opened. If both puts and calls covering the same underlying security are traded, the [Board Broker,] DPM, LMM, or OBO shall determine which type of option will open first, and shall alternate the opening of put series and call series. A [Board Broker,] DPM, LMM, or OBO may conduct the opening rotation in another manner only with the approval of two Floor Officials or at the direction of the appropriate Floor Procedure Committee. A modified opening rotation such as that described in Interpretation .02 to Rule 24.13 may be conducted for certain index options classes.

(c) In the event an underlying security has not opened within a reasonable time after 8:30 a.m. (Chicago time), the [Board Broker,] DPM, LMM, or OBO acting in option contracts on such security shall report the delay to a Floor Official and an inquiry shall be made to determine the cause of the delay. The opening rotation for option contracts in such security shall be delayed until the underlying security has opened unless two Floor Officials determine that the interests of a fair and orderly market are best served by opening trading in the option contracts.

(d) No change.

.02 - .05 No change.

Rule 6.2B Hybrid Opening System

(a) For a period of time before the opening of trading in the underlying security (or in the case of index options, prior to 8:30 a.m., CT), as determined by the appropriate Floor Procedure

Committee (FPC) and announced to the membership via Regulatory Circular, the Hybrid System will accept orders and quotes. The Hybrid System will disseminate to market participants (as defined in Rule 6.45A or 6.45B) information about resting orders in the Book that remain from the prior business day and any orders submitted before the opening. At a randomly selected time within a number of seconds after the primary market for the underlying security disseminates the opening trade or the opening quote (or after 8:30 a.m. for index options unless unusual circumstances exist), the System initiates the opening procedure and sends a notice ("Opening Notice") to market participants who may then submit their opening quotes. The DPM or any appointed LMM for the class must enter opening quotes. Spread orders and contingency orders do not participate in the opening trade or in the determination of the opening price.

(b) After the Opening Notice is sent, the System will calculate and provide the Expected Opening Price ("EOP") and expected opening size ("EOS") given the current resting orders during the EOP Period ("EOP Period"). The appropriate FPC will establish the duration of the EOP Period on a class basis at between five and sixty seconds. The EOP, which will be calculated and disseminated to market participants every few seconds, is the price at which the greatest number of orders in the Book are expected to trade. After the Opening Notice is sent, quotes and orders may be submitted without restriction. An EOP may only be calculated if: (i) there are market orders in the Book, or the Book is crossed (highest bid is higher than the lowest offer) or locked (highest bid equals lowest offer), and (ii) the DPM's quote (or if there is no DPM appointed to the class, at least one quote from either a market-maker or LMM with an appointment in the class) is present and complies with the legal width quote requirements of Rule 8.7(b)(iv).

(c) – (d) No change.

(e) The System will not open a series if one of the following conditions is met:

(i) In classes in which a DPM has been appointed, [T]there is no quote from the DPM for the series. In classes in which no DPM has been appointed, there is no quote from at least one market-maker or LMM with an appointment in the class;

(ii) – (iii) No change.

(f) – (i) No change.

Rule 6.45A Priority and Allocation of Equity Option Trades on the [for] CBOE Hybrid System

Generally: The rules of priority and order allocation procedures set forth in this rule shall apply only to equity option classes designated by the Exchange to be traded on the CBOE Hybrid System and has no applicability to index option and options on ETF classes. The term "market participant" as used throughout this rule refers to a Market-Maker, an in-crowd DPM, an e-DPM, a Remote Market-Maker, and a floor broker representing orders in the trading crowd. The term "in-crowd market participant" only includes an in-crowd Market-Maker, in-crowd DPM, and floor broker representing orders in the trading crowd.

(a) Allocation of Incoming Electronic Orders: The Exchange shall apply, for each class of options, the following rules of trading priority.

(i) * * * * *

(A) No change.

(B) Allocation

(1) No change.

(2) * * * * *

Component A: No change.

Component B: No change.

Final Weighting: The final weighting formula for equity options, which shall be determined by the appropriate FPC and apply uniformly across all options under its jurisdiction, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Initially, the weighting of components A and B shall be equal, represented mathematically by the formula:

$((\text{Component A Percentage} + \text{Component B Percentage})/2) * \text{incoming order size.}$

[The final weighting formula for index options and options on ETFs shall be established by the appropriate FPC and may vary by product. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.]

(C) No change.

(b) No change.

(c) Interaction of Market Participant's Quotes and/or Orders with Orders in Electronic Book

* * * * *

(i) No change.

(ii) * * * * *

Component A: No change.

Component B: No change.

Final Weighting: The final weighting formula for equity options, which shall be determined by the appropriate FPC and apply uniformly across all options under its jurisdiction, shall be

a weighted average of the percentages derived for Components A and B, multiplied by the size of the order(s) in the electronic book. Initially, the weighting of components A and B shall be equal, represented mathematically by the formula: $((\text{Component A Percentage} + \text{Component B Percentage})/2) * \text{electronic book order size}$.

[The final weighting formula for index options and options on ETFs shall be established by the appropriate FPC and may vary by product. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.]

(iii) No change.

(d) No change.

(e) Classes Trading on Hybrid

[By December 31, 2003, Hybrid will be operational in CBOE's 200 most active equity option classes and, by December 31, 2004, Hybrid will be operational in CBOE's 500 most active equity option classes.] The Exchange intends to implement Hybrid floorwide in all other equity classes by the fourth quarter of 2006. [Index option classes and options on ETFs specifically designated by the appropriate Floor Procedure Committee may trade on the Hybrid System. In order to be eligible for trading on Hybrid, index option classes and options on ETFs must utilize an in-crowd Designated Primary Market Maker.]

Interpretations and Policies . . . No change.

Rule 6.45B Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System

Generally: The rules of priority and order allocation procedures set forth in this rule shall apply only to index options and options on ETFs that have been designated by the appropriate

Exchange procedures committee for trading on the CBOE Hybrid System. The term "market participant" as used throughout this rule refers to a Market-Maker, a Remote Market-Maker, an in-crowd DPM or LMM, an e-DPM with an appointment in the subject class, and a floor broker representing orders in the trading crowd. The term "in-crowd market participant" only includes an in-crowd Market-Maker, in-crowd DPM or LMM, and floor broker representing orders in the trading crowd.

(a) Allocation of Incoming Electronic Orders: The appropriate Exchange procedures committee will determine to apply, for each class of options, one of the following rules of trading priority described in paragraphs (i) or (ii). The Exchange will issue a Regulatory Circular periodically specifying which priority rules will govern which classes of options any time the appropriate Exchange committee changes the priority.

(i) Price-Time or Pro-Rata Priority

Price-Time Priority: Under this method, resting quotes and orders in the book are prioritized according to price and time. If there are two or more quotes or orders at the best price then priority is afforded among these quotes or orders in the order in which they were received by the Hybrid System; or

Pro Rata Priority: Under this method, resting quotes and orders in the book are prioritized according to price. If there are two or more quotes or orders at the best price then trades are allocated proportionally according to size (in a pro rata fashion). The executable quantity is allocated to the nearest whole number, with fractions $\frac{1}{2}$ or greater rounded up and fractions less than $\frac{1}{2}$ rounded down. If there are two market participants that both are entitled to an additional $\frac{1}{2}$ contract and there is only one contract remaining to be distributed, the

additional contract will be distributed to the market participant whose quote or order has time priority.

Additional Priority Overlays Applicable to Price-Time or Pro-Rata Priority Methods

In addition to the base allocation methodologies set forth above, the appropriate Exchange procedures committee may determine to apply, on a class-by-class basis, either or both of the following designated market participant overlay priorities. The Exchange will issue a Regulatory Circular periodically which will specify which classes of options are subject to these additional priorities as well as any time the appropriate Exchange procedures committee changes these priorities.

(1) Public Customer: When this priority overlay is in effect, the highest bid and lowest offer shall have priority except that public customer orders shall have priority over non-public customer orders at the same price. If there are two or more public customer orders for the same options series at the same price, priority shall be afforded to such public customer orders in the sequence in which they are received by the System, even if the Pro Rata Priority allocation method is the chosen allocation method. For purposes of this Rule, a Public Customer order is an order for an account in which no member, non-member participant in a joint-venture with a member, or non-member broker-dealer (including a foreign broker-dealer) has an interest.

(2) Participation Entitlement: The appropriate Exchange procedures committee may determine to grant DPMs, LMMs, or e-DPMs participation entitlements pursuant to the provisions of Rule 8.87 or 8.15B. In allocating the participation entitlement, all of the following shall apply:

(A) To be entitled to their participation entitlement, a DPM's or LMM's or e-DPM's order and/or quote must be at the best price on the Exchange.

(B) A DPM or LMM or e-DPM may not be allocated a total quantity greater than the quantity that the DPM or LMM or e-DPM is quoting (including orders not part of quotes) at that price. If Pro Rata Priority is in effect, and the DPM's or LMM's or e-DPM's allocation of an order pursuant to its participation entitlement is greater than its percentage share of quotes/orders at the best price at the time that the participation entitlement is granted, the DPM or LMM or e-DPM shall not receive any further allocation of that order.

(C) In establishing the counterparties to a particular trade, the DPM's or LMM's or e-DPM's participation entitlement must first be counted against the DPM's or LMM's or e-DPM's highest priority bids or offers.

(D) The participation entitlement shall not be in effect unless the Public Customer priority is in effect in a priority sequence ahead of the participation entitlement and then the participation entitlement shall only apply to any remaining balance.

(ii) **Ultimate Matching Algorithm ("UMA"):** Under this method, a market participant who enters a quotation and whose quote is represented by the disseminated CBOE best bid or offer ("BBO") shall be eligible to receive allocations of incoming electronic orders for up to the size of its quote, in accordance with the principles described below. As an initial matter, if the number of contracts represented in the disseminated quote is less than the number of contracts in an incoming electronic order(s), the incoming electronic order(s) shall only be entitled to receive a number of contracts up to the size of the disseminated quote, in accordance with Rule 6.45B(a)(ii)(B). The balance of the electronic order will be eligible to

be filled at the refreshed quote either electronically (in accordance with paragraph (a)(ii)(B) below) or manually (in accordance with Rule 6.45B(b)) and, as such, may receive a split price execution.

(A) Priority of Orders in the Electronic Book

(1) Public Customer Orders: Public customer orders in the electronic book have priority. Multiple public customer orders in the electronic book at the same price are ranked based on time priority. If a public customer order(s) in the electronic book matches, or is matched by, a market participant quote, the public customer order(s) shall have priority and, the balance of the incoming order, if any, will be allocated pursuant to Rule 6.45B(a)(ii).

(2) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate Exchange procedures committee determines to allow certain types of broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer orders in the electronic book at the best price shall be deemed one "market participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "market participant" shall be distributed among each broker-dealer order comprising the "market participant" pursuant to Rule 6.45B(a)(ii)(B).

(B) Allocation

(1) Market Participant Quoting Alone at BBO: When a market participant is quoting alone at the disseminated CBOE BBO and is not subsequently matched in the quote by other market participants prior to execution, it will be entitled to receive incoming electronic order(s) up to the size of its quote. If another market participant

joins in the disseminated quote prior to execution of an incoming electronic order(s) such that more than one market participant is quoting at the BBO, incoming electronic order(s) will be distributed in accordance with (B)(2) below.

(2) More than One Market Participant Quoting at BBO: When more than one market participant is quoting at the BBO, inbound electronic orders shall be allocated pursuant to the following allocation algorithm:

Allocation Algorithm

<u>Incoming Order Size *</u>	<u>(Equal Percentage based on</u>	<u>(Pro-rata Percentage based on</u>
	<u>number of market</u>	<u>± size of market participant</u>
	<u>participants quoting at</u>	<u>quotes)</u>
	<u>BBO)</u>	
	<u>(Component A)</u>	<u>(Component B)</u>
	<hr/>	
	<u>2</u>	

Where:

Component A: The percentage to be used for Component A shall be an equal percentage, derived by dividing 100 by the number of market participants quoting at the BBO.

Component B: Size Prorata Allocation. The percentage to be used for Component B of the Allocation Algorithm formula is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote.

Final Weighting: The final weighting formula, which shall be established by the appropriate Exchange procedures committee and may vary by product, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.

(C) Participation Entitlement: If a DPM, LMM, or e-DPM is eligible for an allocation pursuant to the operation of the Algorithm described in paragraph (a) of Rule 6.45B, the DPM, LMM, or e-DPM may be entitled to receive an allocation (not to exceed the size of its quote) equal to either:

- (1) the greater of the amount it would be entitled to pursuant to the participation right established pursuant to Rule 8.87 or 8.15B (and Regulatory Circulars issued thereunder) or the amount it would otherwise receive pursuant to the operation of the Algorithm described above provided, however, that in calculating the DPM's or LMM's allocation under the Algorithm, DPMs or LMMs utilizing more than one membership in the trading crowd where the subject class is traded shall count as two market participants for purposes of Component A of the Algorithm; or
- (2) the amount it would be entitled to pursuant to the participation right established pursuant to Rule 8.87 or 8.15B (and Regulatory Circulars issued thereunder); or
- (3) The amount it would be entitled to receive pursuant to the operation of the Algorithm described above provided, however, that in calculating the DPM's or LMM's allocation under the Algorithm, DPMs or LMMs utilizing more than one

membership in the trading crowd where the subject class is traded shall count as two market participants for purposes of Component A of the Algorithm.

The appropriate Exchange procedures committee shall determine which of the preceding three entitlement formulas will be in effect on a class by class basis. All pronouncements regarding the entitlement formula shall be made via Regulatory Circular. The participation entitlement percentage is expressed as a percentage of the remaining quantity after all public customer orders in the electronic book have been executed.

(b) Allocation of Orders Represented in Open Outcry: The allocation of orders that are represented in the trading crowd by floor brokers (including DPMs acting as agent under 8.85(b)) shall be as described below in subparagraphs (b)(i) and (b)(ii). With respect to subparagraph (b)(ii), the floor broker representing the order (including DPMs acting as agent under 8.85(b)) shall determine the sequence in which bids (offers) are made.

(i) Priority of Orders in the Electronic Book

(A) Public Customer Orders: Public customer orders in the electronic book have priority. Multiple public customer orders in the electronic book at the same price are ranked based on time priority. If a public customer order(s) in the electronic book matches, or is matched by, an oral bid or offer provided by a member of the trading crowd, the public customer order(s) shall have priority and the balance of the order, if any, will be allocated in open outcry in accordance with paragraph (b)(ii).

(B) Broker-dealer Orders: If pursuant to Rule 7.4(a) the appropriate Exchange procedures committee determines to allow broker-dealer orders to be placed in the electronic book, then for purposes of this rule, the cumulative number of broker-dealer

orders in the electronic book at the best price shall be deemed one "book market participant" regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "book market participant" shall be in accordance with paragraph (ii) below and shall be distributed among each broker-dealer order comprising the "book market participant" in accordance with the Allocation Algorithm formula described in paragraph 6.45B(a)(ii)(B).

(ii) Allocation

(A) The highest bid (lowest offer) shall have priority.

(B) If two or more bids or offers represent the best price, each of which is NOT a book market participant, priority shall be afforded in accordance with the allocation principles contained in CBOE Rule 6.45(a) or (b) and NOT Rule 6.45B(b).

If two or more bids (offers) represent the best price, one of which represents a book market participant, priority shall be afforded to the market participants in the sequence in which their bids (offers) were made. Provided however that the first market participant to respond shall be entitled to 70% of the order. The second market participant to respond (if ascertainable) shall be entitled to 70% of the remainder of the order (i.e., 70% of 30%). The balance of the order shall be apportioned equally among the remaining market participants bidding (offering) at the same price and the book market participant (as defined in Rule 6.45B(b)(i)(B) above). If it is not possible to determine the order in which market participants responded, the balance of the order shall be apportioned equally among the remaining market participants bidding (offering) at the same price and, if applicable, the book market participant.

In the event a market participant declines to accept any portion of the available contracts, any remaining contracts shall be apportioned equally among the other participants who bid (offered) at the best price (including the book market participant, if applicable) at the time the market was established until all contracts have been apportioned. The floor broker representing the order (including DPMs acting as agent under 8.85(b)) shall determine the sequence in which bids (offers) are made.

(iii) Exception: Complex Order Priority:

A member holding a spread, straddle, or combination order (or a stock-option order or security future-option order as defined in Rule 1.1(ii)(b) and Rule 1.1(zz)(b), respectively) and bidding (offering) on a net debit or credit basis (in a multiple of the minimum increment) may execute the order with another member without giving priority to equivalent bids (offers) in the trading crowd or in the electronic book provided at least one leg of the order betters the corresponding bid (offer) in the book. Stock-option orders and security future-option orders, as defined in Rule 1.1(ii)(a) and Rule 1.1(zz)(a), respectively, have priority over bids (offers) of the trading crowd but not over bids (offers) of public customers in the limit order book.

(c) Interaction of Market Participant's Quotes and/or Orders with Orders in Electronic

Book

Market participants, as defined in Rule 6.45B, may submit quotes or orders electronically to trade with orders in the electronic book. A floor broker market participant may only represent as agent customer orders or orders from unaffiliated broker-dealers. When a market participant's quote or order interacts with the order in the book, a trade occurs, CBOE will disseminate a last sale report, and the size of the book order will be decremented to reflect the execution.

In the limited instance when the appropriate Exchange procedures committee has determined that the allocation of incoming electronic orders shall be pursuant to price-time priority as described in Rule 6.45B(a)(i), allocation of orders in the Electronic Book pursuant to this paragraph shall be based on time-priority (i.e., allocated to the first market participant to interact with the order in the book, up to the size of that market participant's order). In all other instances, the allocation of the book order shall be as follows:

(i) One Market Participant Trades with the Electronic Book: If only one market participant submits an electronic order or quote to trade with an order in the electronic book, that market participant shall be entitled to receive an allocation of the order in the electronic book up to the size of the market participant's order.

(ii) Multiple Market Participant Trade with the Electronic Book: Each market participant that submits an order or quote to buy (sell) an order in the electronic book within a period of time not to exceed 5-seconds of the first market participant to submit an order ("N-second group") shall be entitled to receive an allocation of the order in the electronic book pursuant to the following allocation algorithm:

Allocation Algorithm

<u>Electronic Book</u>	<u>(Equal percentage based on</u>	<u>(Size pro-rata percentage based</u>
<u>Order(s) Size</u> *	<u>number of members of "N-</u>	<u>on size of orders of "N-second</u>
	<u>second group")</u>	<u>group" members)</u>
	<u>(Component A)</u>	<u>(Component B)</u>

2

Where:

Component A: The percentage to be used for Component A shall be an equal percentage derived by dividing 100 by the number of market participant's in the "N-second group."

Component B: Size Prorata Allocation. The percentage to be used for Component B of the Allocation Algorithm formula is that percentage that each market participant of the "N-second group's" quote at the best price represents relative to the total number of contracts of all market participants of the "N-second group." The appropriate Exchange procedures committee may determine that the maximum quote size to be used for each market participant in the Component B calculation shall be no greater than the cumulative size of orders resident in the electronic book at the best price at which market participants are attempting to buy (sell).

Final Weighting: The final weighting formula, which shall be established by the appropriate Exchange procedures committee and may vary by product, shall be a weighted average of the percentages derived for Components A and B, multiplied by the size of the order(s) in the electronic book. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.

Length of "N-Second Group" Timer: The appropriate Exchange procedures committee will determine the length of the "N-second group" timer on a class by class basis provided, however, that the duration of the "N-second group" timer shall not exceed five seconds. Any changes to the duration of the "N-second group" timer shall be announced via Regulatory Circular.

(iii) Participation Entitlement: There is no DPM or LMM participation entitlement applicable to orders allocated pursuant to this paragraph (c).

(d) Quotes Interacting with Quotes

(i) In the event that a Market-Maker's disseminated quotes interact with the disseminated quote(s) of other Market-Makers, resulting in the dissemination of a "locked" quote (e.g., \$1.00 bid - 1.00 offer), the following shall occur:

(A) The Exchange will disseminate the locked market and both quotes will be deemed "firm" disseminated market quotes.

(B) The Market-Makers whose quotes are locked will receive a quote update notification advising that their quotes are locked, unless the "counting period" referenced below is set to zero seconds.

(C) When the market locks, a "counting period" will begin during which Market-Makers whose quotes are locked may eliminate the locked market. Provided, however, that in accordance with subparagraph (A) above a Market-Maker will be obligated to execute customer and broker-dealer orders eligible for automatic execution pursuant to Rule 6.13 at his disseminated quote in accordance with Rule 8.51. If at the end of the counting period the quotes remain locked, the locked quotes will automatically execute against each other in accordance with the allocation algorithm described above in Rule 6.45B(a). The length of the counting period will be established by the appropriate Exchange procedures committee, may vary by product, and will not exceed one second.

(ii) **Inverted Quotes:** The Hybrid System will not disseminate an internally crossed market (i.e., the CBOE best bid is higher than the CBOE best offer). If a Market-Maker submits a quote ("incoming quote") that would invert an existing quote ("existing quote"), the Hybrid System will change the incoming quote such that it locks the first quote and send a notice to the second Market-Maker indicating that its quote was changed. Locked markets are handled

in accordance with paragraph (d)(i) above. During the lock period, if the existing quote is cancelled subsequent to the time the incoming quote is changed, the incoming quote will automatically be restored to its original terms.

Interpretations and Policies . . .

.01 Principal Transactions: Order entry firms may not execute as principal against orders they represent as agent unless: (i) agency orders are first exposed on the Hybrid System for at least thirty (30) seconds, (ii) the order entry firm has been bidding or offering for at least thirty (30) seconds prior to receiving an agency order that is executable against such bid or offer, or (iii) the order entry firm proceeds in accordance with the crossing rules contained in Rule 6.74.

.02 Solicitation Orders. Order entry firms must expose orders they represent as agent for at least thirty (30) seconds before such orders may be executed electronically via the electronic execution mechanism of the Hybrid System, in whole or in part, against orders solicited from members and non-member broker-dealers to transact with such orders.

Rule 7.4 Obligations for Orders

(a) Eligibility and Acceptance

(1) **Eligibility:** Public customer orders are eligible for entry into the electronic book.

Market participants, as defined in Rule 6.45A[(a)] or 6.45B, shall be eligible to submit orders for entry into the book. The appropriate FPC may determine on an issue-by-issue basis that the following types of orders may also be eligible for entry into the electronic book:

* * * * *

(2) **Acceptance:** An Order Book Official ("OBO") shall ordinarily be expected to accept orders for all option contracts of the class or classes to which his appointment extends that are properly submitted for entry into the electronic book. An Order Book Official shall not accept orders from any source other than a member or, with respect to orders submitted through the Intermarket Options Linkage in index options classes on the Hybrid Trading System that are not assigned to a DPM, from an exchange (other than CBOE) that is a

participant in the Intermarket Options Linkage Plan. For the purposes of this rule, an order shall be deemed to be from a member if the order is placed with an Order Book Official by a person associated with a member or through the telecommunications system of a member firm.

For Index option classes on the Hybrid Trading System that are not assigned a DPM, the OBO shall be responsible for (1) routing linkage Principal Acting as Agent (P/A) Orders and Satisfaction orders (utilizing the LMM's account for the benefit of an underlying order) to other markets based on prior written instructions that must be provided by the LMM to the OBO; (2) handling all linkage orders or portions of linkage orders received by the Exchange that are not automatically executed.

(b) Types of Orders. Orders which may be placed with an Order Book Official or directly into the electronic book, shall include the following:

(i) – (iii) No change.

(iv) Orders from market participants (as defined in Rule 6.45A[(a)(2))] or 6.45B).

(c) – (g) No change.

Interpretations and Policies . . .

.01 - .05 No change.

.06 Electronic execution of certain orders on the Exchange's electronic limit order book is provided for under sub-paragraphs (d)(iv) and (v) of Rule 6.8, subparagraphs (a)-(d) of Rules 6.45A and 6.45B, and subparagraph (b) of Rule 6.13.

Rule 8.14 Index Hybrid Trading System Classes: Market-Maker Participants

(a) Generally: The Exchange procedures committee may authorize for trading on the CBOE Hybrid Trading System or Hybrid 2.0 Program index options and options on ETFs currently trading on the Exchange. The appropriate Exchange procedures committee shall determine the eligible categories of market maker participants for option classes currently trading on the Exchange, which may include:

Designated Primary Market-Makers ("DPM"): Market makers as defined in Rule 8.80 whose activities are governed by, among other rules, CBOE Rules 8.80 – 8.91.

Lead Market-Makers ("LMM"): Market makers as defined in Rule 8.15A whose activities are governed by, among other rules, CBOE Rule 8.15A.

Electronic DPMs ("e-DPM"): Market makers as defined in Rule 8.92 whose activities are governed by, among other rules, CBOE Rules 8.92 – 8.94.

Market-Makers ("MM"): Market makers as defined in Rule 8.1 whose activities are governed by, among other rules, CBOE Rules 8.1- 8.11.

(b) Each class designated by the appropriate Exchange committee for trading on Hybrid or the Hybrid 2.0 Platform shall have an assigned DPM or LMM. The appropriate Exchange committee may determine to designate classes for trading on Hybrid or the Hybrid 2.0 Platform without a DPM or LMM provided the following conditions are satisfied:

- 1. There are at least four (4) market makers quoting in the class;**
- 2. Each market maker with an appointment in the class is subject to the continuous quoting obligations imposed by CBOE Rule 8.7(d);**
- 3. In the event CBOE activates request-for-quote ("RFQ") functionality in index classes, each MM will have an obligation to respond to that percentage of RFQs as determined by the**

appropriate Exchange procedures committee, provided however, that such percentage shall not be less than 80%. Regarding RFQ responses:

(i) MMs must comply with the bid-ask differential contained in Rule 8.7(b)(iv).

(ii) Responses must be submitted within the amount of time specified by the appropriate Exchange procedures committee from the time the RFQ is entered.

(iii) Responses must be for a minimum of ten contracts or a size specified by the appropriate Exchange procedures committee, whichever is greater.

(iv) MMs responding to an RFQ must maintain a continuous market in that series for a subsequent 30-second period (or for some other time specified by the appropriate EPC) or until his/her quote is filled in its entirety. A MM may change his/her quotes during this 30-second period but he/she may not cancel them without replacing them. If the MM does cancel without replacing the quote his/her response to the RFQ will not count toward the MM's response rate requirement set forth above. A MM will be considered to have responded to the RFQ if he/she has a quote in the market for the series at the time the RFQ is received and he/she maintains it for the appropriate period of time.

4. In order to allow a multiply-listed product trade without a DPM or LMM, the Exchange must amend its Market-Maker obligation rules (and receive Commission approval thereof) to indicate how orders will be submitted to other exchanges on behalf of Market-Makers in accordance with the Intermarket Options Linkage Plan requirements.

Rule 8.15 Lead Market Makers and Supplemental Market Makers in Non-Hybrid Classes

No change.

Rule 8.15A Lead Market Makers in Hybrid Classes

(a) Assignment, Removal, and Evaluation of LMMs: The appropriate Market Performance Committee (the "Committee") may appoint one or more market makers in good standing with an appointment in an option class for which a DPM has not been appointed as Lead Market-Makers ("LMMs").

(i) LMMs shall be appointed on the first day following an expiration for a period of no less than one month ("expiration month") and may be assigned to a class with one or more LMMs.

A. Factors to be considered by the Committee in selecting LMMs include: adequacy of capital, experience in trading index options or options on ETFs, presence in the trading crowd, adherence to Exchange rules and ability to meet the obligations specified below. An individual may be appointed as an LMM for one expiration month at a time. When individual members are associated with one or more other members, only one member may receive an LMM appointment.

B. Removal of LMMs may be effected by the Committee on the basis of the failure of one or more LMMs assigned to the class to meet the obligations set forth below, or any other applicable Exchange rule. An LMM removed under this rule may seek review of that decision under Chapter XIX of the Rules.

C. If one or more LMMs are removed or if for any reason an LMM shall no longer be eligible for or shall resign his appointment or shall fail to perform his duties, the Committee may appoint an interim LMM to complete the monthly obligations of the former LMM.

D. The Committee shall review and evaluate the conduct of LMMs, including but not limited to compliance with Rules 8.1, 8.2, 8.3, and 8.7 and may hold all LMMs responsible for the performance of each LMM in the class.

(b) LMM Obligations: LMMs are required to:

(i) provide continuous market quotations that comply with the bid/ask differentials permitted by Rule 8.7(b) in 90% of the option series within their assigned classes;

(ii) assure that each of its displayed market quotations is honored for at least the number of contracts prescribed pursuant to Rule 8.51;

(iii) perform the above obligations for a period of one expiration month commencing on the first day following an expiration. Failure to perform such obligations for such time may result in suspension of up to three months from trading in all series of the option class;

(iv) participate in the Hybrid Opening System; and

(v) Respond to any open outcry request for quote by a floor broker with a two-sided quote complying with the current quote width requirements of Rule 8.7(b)(iv) for a minimum of ten contracts for non-broker-dealer orders and one contract for broker-dealer orders.

(vi) Act as agent for orders routed to other exchanges that are participants in the Intermarket Options Linkage Plan. The LMM's account shall be used for P/A and Satisfaction orders routed by the Order Book Official for the benefit of an underlying order, and the LMM shall be responsible for any charges incurred from the execution of such orders. LMMs shall also provide written instructions to Order Book Officials regarding the routing of P/A and Satisfaction orders.

8.15B Participation Entitlement of LMMs

(a) The appropriate Market Performance Committee may establish, on a class by class basis, a

participation entitlement formula that is applicable to LMMs.

(b) To be entitled to a participation entitlement, the LMM must be quoting at the best bid/offer on the Exchange and the LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange. The participation entitlement is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied.

(c) The LMM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange; and, 30% when there are three or more Market-Makers also quoting at the best bid/offer on the Exchange. If more than one LMM is entitled to a participation entitlement, such entitlement shall be distributed equally among all eligible LMMs provided, however, that an LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange.

The appropriate Market Performance Committee may determine, on a class-by-class basis, to decrease the LMM participation entitlement percentages from the percentages specified in paragraph (c). Such changes will be announced to the membership in advance of implementation via Regulatory Circular.

* * * * *

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, as amended. 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

The Exchange currently trades equity options, index options, and options on exchange-traded funds ("ETFs") on its Hybrid Trading System ("Hybrid"). Currently, one prerequisite for trading a class on Hybrid, that there be a DPM assigned to the class, prevents the Exchange from introducing Hybrid into those classes in which there is no DPM. The Exchange states that the purpose of this rule filing is to extend the Hybrid trading rules to classes of index options and options on ETFs (collectively, "index classes") without an assigned DPM. In this regard, the proposal would allow the trading of these index classes on Hybrid either with a DPM, a LMM, or without a DPM or LMM in classes where there are a requisite number of assigned MMs.

I. Trading Without an LMM or DPM

The Exchange proposes to adopt new CBOE Rule 8.14 to specify the permitted categories of market participants in index classes. The proposed rule allows the appropriate Exchange procedures committee ("EPC"), for classes currently trading on the Exchange, to authorize for trading on the CBOE Hybrid Trading System or Hybrid 2.0 Program index options and options on ETFs. Additionally, the appropriate EPC would determine the eligible categories of market maker participants for each of these option classes currently trading on the Exchange, which may include DPMs, LMMs, Electronic DPMs ("e-DPMs"), and MMs.⁵ In this regard, the Exchange believes that the appropriate EPC is in the best position to determine which trading

platform (Hybrid or Hybrid 2.0) maximizes the competitive position of the Exchange and, accordingly, would make this determination along with the determination of which categories of market participants will trade in the product.

Proposed paragraph (b) of CBOE Rule 8.14 also provides that each class designated for trading on Hybrid must have a DPM or LMM assigned to it, unless there are at least four (4) MMs quoting in the class and each MM that has an appointment in the class is subject to the continuous quoting obligations imposed by CBOE Rule 8.7(d).⁶ In those classes in which there is no DPM or LMM, the proposed rule provides that in the event the CBOE activates request-for-quote ("RFQ") functionality, each MM would have an obligation to respond to that percentage of RFQs as determined by the appropriate EPC provided, however, that such percentage shall not be less than 80%. The following requirements would be applicable to RFQ responses:⁷

- MMs must comply with the bid-ask differential contained in CBOE Rule 8.7(b)(iv);
- Responses must be submitted within the amount of time specified by the appropriate EPC from the time the RFQ is entered;
- Responses must be for a minimum of ten (10) contracts or a size specified by the appropriate EPC, whichever is greater; and
- MMs responding to an RFQ must maintain a continuous market in that series for a subsequent 30-second period (or for some other time specified by the appropriate EPC)

⁵ CBOE Rule 8.1 provides that the term "Market-Maker" includes Remote Market-Makers, as defined in CBOE Rule 8.4.

⁶ CBOE Rule 8.7(d) governs the quoting obligations for MMs in Hybrid classes.

⁷ These requirements are based on similar requirements contained in CBOE Rule 44.4(b).

or until his/her quote is filled in its entirety. A MM may change his/her quotes during this 30-second period but may not cancel them without replacing them. If the MM does cancel without replacing the quote, his/her response to the RFQ would not count toward the MM's response rate requirement set forth above. A MM would be considered to have responded to the RFQ if he/she has a quote in the market for the series at the time the RFQ is received and he/she maintains it for the appropriate period of time.

Proposed CBOE Rule 8.14(b)(4) provides that in order to allow a multiply-listed product trade without a DPM or LMM, the Exchange will need to amend its Market-Maker obligation rules (and receive Commission approval thereof) to indicate how orders will be submitted to other exchanges on behalf of Market-Makers in accordance with the Intermarket Options Linkage Plan requirements.

II. Index Classes Trading with an LMM: LMM Obligations

The Exchange operates an LMM system in several index classes. Current CBOE Rule 8.15, Lead Market-Makers and Supplemental Market-Makers, governs the LMM appointment process and imposes obligations upon LMMs. The Exchange proposes to adopt new CBOE Rule 8.15A, Lead Market Makers in Hybrid Classes, which mimics current CBOE Rule 8.15 with few changes.⁸ As an initial matter, the Exchange eliminates reference to Supplemental Market-Makers as they would not exist in Hybrid. Next, with respect to appointments of LMMs, the Exchange eliminates all references in the proposed rules to "zones" as LMMs in Hybrid would not be assigned to zones. Instead, there would only be one LMM at

⁸ The Exchange proposes to amend CBOE Rule 8.15 to limit its application to non-Hybrid classes.

any time in a particular class. The Exchange anticipates that, in any given class, there may be several approved LMMs; however, only one LMM would function at any given time.

Current CBOE Rule 8.15(b) governs LMM obligations and the Exchange proposes to adopt similar obligations in proposed paragraph (b) of CBOE Rule 8.15A. In this regard, the Exchange proposes to adopt in paragraph (b)(i) of proposed CBOE Rule 8.15A a continuous quoting obligation to mandate LMMs in a class to quote a legal width market in 90% of the option series.

This requirement would apply at all times, not just during the opening rotation. Proposed paragraph (b)(ii) would obligate LMMs to assure that their displayed market quotations are honored for at least the number of contracts prescribed pursuant to CBOE Rule 8.51 (i.e., the firm quote rule). Proposed paragraph (b)(iii) requires an LMM to perform the above obligations for a period of one (1) expiration month commencing on the first day following an expiration. Failure to perform such obligations for such time may result in suspension of up to three (3) months from trading in all series of the option class. Proposed paragraph (b)(iv) requires LMMs to participate in the Hybrid Opening System (as described in CBOE Rule 6.2B). As such, LMMs would be required to submit quotes during the opening rotation. Proposed paragraph (v) requires LMMs to respond to any open outcry request for quote by a floor broker with a two-sided quote complying with the current quote width requirements of CBOE Rule 8.7(b)(iv) for a minimum of ten (10) contracts for non-broker-dealer orders and one (1) contract for broker-dealer orders.

The Exchange also proposes to modify rules to accommodate trading in multiply listed classes that would be subject to the Intermarket Options Linkage. DPMs currently handle linkage functions with respect to routing of linkage orders to other markets on behalf of customer orders and representing inbound linkage orders from other markets that are not

automatically executed on the CBOE. The Exchange believes the DPMs linkage obligations can be carried out by Order Book Officials ("OBOs") and LMMs for Index option classes on the Hybrid Trading System that are assigned an LMM. The Exchange states that, in essence, OBOs would represent inbound linkage order and would be responsible for transmitting outbound linkage orders on behalf of underlying customer orders but would do so using the LMMs trading account and with instruction and input from the LMM. An LMM, as opposed to a DPM, currently does not have agency obligations. For this reason, the Exchange proposes to add an LMM obligation in proposed paragraph (vi) of proposed CBOE Rule 8.15A to require an LMM, in multiply-listed products, to act as agent for orders routed to other exchanges that are participants in the Intermarket Options Linkage Plan.⁹ The proposed paragraph also provides that an LMM's account would be used for Principal Acting as Agent ("P/A") and Satisfaction orders routed by the OBO for the benefit of an underlying customer order, and the LMM would be responsible for any charges incurred from the execution of such orders.

The Exchange proposed to make a corresponding change to CBOE Rule 7.4(a)(2) to permit OBOs to receive Linkage orders from exchanges that are participants in the Intermarket Options Linkage Plan (other than CBOE).¹⁰ In this regard, the proposed change to CBOE Rule 7.4(a)(2) also provide that, for Index option classes on the Hybrid Trading System that are not assigned a DPM, the OBO shall be responsible for (1) routing linkage P/A and Satisfaction orders (utilizing the LMM's account) to other markets based on prior written instructions that

⁹ See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (Aug. 4, 2000) (order approving the Options Intermarket Linkage Plan submitted by the American Stock Exchange LLC, CBOE, and International Securities Exchange LLC ("ISE")).

must be provided by the LMM to the OBO; and (2) handling all linkage orders or portions of linkage orders received by the Exchange that are not automatically executed. This proposed amendment to CBOE Rule 7.4(a)(2) provides OBOs with the ability to route outbound linkage orders to other exchanges and to handle inbound linkage orders received from other exchanges. In this regard, orders routed by the OBO in accordance with this rule would be routed in accordance with written instructions provided by the LMM.¹¹ With respect to handling inbound linkage orders, OBOs would handle only those orders that do not automatically execute via the Exchange's systems. The CBOE notes that the vast majority of inbound linkage orders that receive executions are automatically executed.

There are some obligations currently applicable in CBOE Rule 8.15 that the Exchange does not propose to adopt in CBOE Rule 8.15A. First, the Exchange proposes not to adopt the requirement that an LMM facilitate imbalances of customer orders in all series.¹² Instead, the Exchange proposes to replace this obligation with a requirement that LMMs respond to any open outcry RFQ with a two-sided legal-width quote. In practice, LMMs facilitate order imbalances in open outcry. Accordingly, the Exchange believes that obligating an LMM to respond to all floor broker RFQs should achieve the same result. Second, the Exchange also proposes to not adopt in CBOE Rule 8.15A the language contained in CBOE Rule 8.15(d). CBOE Rule 8.15(d) operates under the assumption that only the LMM disseminates a quote, for which the entire trading crowd is required under CBOE Rule 8.51 to be firm. In a Hybrid system, each MM posts

¹⁰ The Exchange makes minor changes to CBOE Rules 7.4(a)(1) and (b)(iv), and Interpretations and Policies .06 thereto, to include references to CBOE Rule 6.45B in each place where CBOE Rule 6.45A is mentioned.

¹¹ All linkage fees incurred for routing P/A and Satisfaction orders for the benefit of underlying orders would be borne by the LMM.

its own quotes, hence there is no need for MMs to know which variables an LMM uses in its pricing calculation.

III. LMM Participation Entitlement

Today, LMMs do not receive participation entitlements nor does CBOE Rule 8.87 address granting a participation entitlement to LMMs. Because LMMs serve in much the same capacity as a DPM and perform many of the same functions as an e-DPM, the Exchange believes that it is reasonable to allow the LMM to receive a participation entitlement. Accordingly, the Exchange proposes to adopt new CBOE Rule 8.15B, Participation Entitlement of LMMs, which is based on CBOE Rule 8.87, Participation Entitlement of DPMs and e-DPMs.

As proposed, paragraph (a) would allow the appropriate Market Performance Committee to establish, on a class by class basis, a participation entitlement formula that is applicable to LMMs. Proposed paragraph (b) states that, to be entitled to a participation entitlement, the LMM must be quoting at the best bid/offer on the Exchange and the LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange.¹³

Paragraph (c) establishes the percentages of the participation entitlement at the same levels currently in effect in CBOE Rule 8.87, which means that the LMM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange; and 30% when there are three or more Market-Makers also quoting at the best

¹² CBOE Rule 8.15(b)(2).

bid/offer on the Exchange. If more than one LMM is entitled to a participation entitlement, such entitlement shall be distributed equally among all eligible LMMs provided, however, that an LMM may not be allocated a total quantity greater than the quantity for which the LMM is quoting at the best bid/offer on the Exchange.

Finally, proposed paragraph (c) also allows the appropriate Market Performance Committee ("MPC") to determine, on a class-by-class basis, to decrease the LMM participation entitlement percentages from the percentages specified in paragraph (c). The Exchange believes that this ability to decrease the participation entitlement is more important on the index product side, where trading crowds often are significantly larger than they are on the equity side. For example, awarding an LMM a 30% entitlement in a product with 100 quoters could be disproportionate. For this reason, the appropriate MPC may lower the percentages. Any such reductions would be announced to the membership via Regulatory Circular in advance of implementation. The Exchange states that, in the unlikely event the Exchange seeks to increase the participation entitlement, obviously it will submit a "regular-way" rule filing to the Commission.

The Exchange believes it is reasonable to grant LMMs a participation entitlement for several reasons, chief among them being the LMM would perform many of the same functions that DPMs perform. First, an LMM, like a DPM, has enhanced quoting obligations, as evidenced by the proposed 90% continuous quoting obligation. In this regard, MMs have only a 60% continuous quoting obligation, which means that LMMs must quote 50% more series than

¹³ The participation entitlement is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied.

MMs.¹⁴ Second, an LMM's proposed obligations are as stringent as are those of e-DPMs, who also receive participation entitlements. In this regard, e-DPMs, who share in the participation entitlement pursuant to CBOE Rule 8.87, have the same 90% continuous quoting obligation as proposed herein for LMMs.¹⁵ Third, LMMs are required to participate in the Hybrid Opening System in the same fashion as DPMs, while there is no such requirement for MMs. These heightened obligations justify the granting of a participation entitlement to LMMs.

IV. Allocation of Trades

Current CBOE Rule 6.45A governs the allocation of trades on the Hybrid System. The Exchange proposes to adopt new CBOE Rule 6.45B, which is substantially similar in most respects to CBOE Rule 6.45A, and restrict its application to index classes. The Exchange proposes to amend current CBOE Rule 6.45A, therefore, to limit its applicability to equity classes only.

¹⁴ Mathematically, a 90% quoting obligation is 50% greater than a 60% quoting obligation $((90-60)/60)$.

¹⁵ See CBOE Rule 8.93(i).

A. Allocation of Incoming Electronic Orders: CBOE Rule 6.45B(a)

Regarding the allocation of incoming electronic orders, CBOE Rule 6.45B(a) provides the appropriate EPC with the ability to adopt on a class by class basis one of two allocation models, both of which have been approved by the Commission in different contexts. The first allocation model is a scaled-down version of the Exchange's Screen-Based Trading ("SBT") Rule 43.1, while the second allocation model is the Exchange's current Ultimate Matching Algorithm ("UMA"). The Exchange believes it appropriate for the EPC to make these determinations because it has the greatest familiarity with the trading dynamics of each product under its jurisdiction, which makes it best-positioned to determine which allocation model to utilize in order to enhance the competitiveness of the Exchange in that product.¹⁶ For example, the EPC may determine that trading of a particular product would be enhanced by utilizing a strict price-time allocation model. At the same time, the EPC may determine that a second index product, which perhaps does not trade as actively as the first index product, may be better suited to using UMA for its allocation model. The ability to choose from several allocation models provides flexibility to the EPC to choose the allocation model it believes is best-suited for a particular product.

1. CBOE Rule 6.45B(a)(i): Price-Time or Pro-Rata Priority

The first allocation model comes from the Exchange's SBT rules and is substantially reproduced in proposed paragraph (a)(i). Pursuant to this model, the Exchange may on a class

¹⁶ The "trading dynamics" of a particular product refers to numerous factors including, but not limited to: type of order flow (customer vs. institutional); size of order flow (small vs. large); and where execution occurs (in open outcry or electronically).

by class basis adopt either a price-time or pro-rata allocation model.¹⁷ Accordingly, the EPC committee would determine whether to utilize a price-time model in which the first quote or order at the best price has priority. Alternatively, the committee may determine to utilize a pro-rata priority model whereby the size of an individual's allocation of an incoming order is a function of the relative size of his/her quote/order compared to all others at the same price.

Additionally, the Exchange may determine to utilize one or two priority overlays in any class using a price-time or pro-rata allocation model: public customer priority¹⁸ or participation entitlement priority.¹⁹ A priority overlay functions as an exception to the general priority rule in effect. Under the public customer overlay, public customers have priority over all others, and multiple public customer orders are ranked based on time priority. Under the participation entitlement overlay, DPMs/e-DPMs/LMMs at the best price receive their participation entitlement provided their order/quote is at the best price on the Exchange.

As an example, in a class using price-time priority with a public customer priority overlay, the first order/quote at the best price has priority, unless there is a public customer order at that best price, in which case the public customer moves to the front of the line and takes priority (up to the size of his/her order). In this example, after the public customer order is satisfied, any remainder of the order would be allocated using the price-time priority principles.

¹⁷ See CBOE Rule 43.1(a)(1) (price-time priority) and (a)(2) (pro rata priority). The ISE utilizes a pro rata priority model for market-makers and non-customers (see ISE Rule 713.01) while the Boston Options Exchange ("BOX") utilizes the price-time priority model (see BOX Trading Rules, Chapter V, Sec. 16).

¹⁸ See CBOE Rule 43.1(b)(1). Under the public customer priority model, public customers at the highest bid or lowest offer will have priority over non-public customers at the same price.

¹⁹ See CBOE Rule 43.1(b)(3) (trade participation right priority).

Both priority overlays may be in effect in a particular class at one time or, alternatively, neither need be operational. The participation right overlay is akin to the DPM participation entitlement. In determining which overlays would be in effect, the EPC is bound by the requirement that it may not offer a participation entitlement unless it also offers public customer priority and that the public customer priority overlay applies before the participation entitlement does.²⁰

2. CBOE Rule 6.45B(a)(ii): UMA

Under the proposal, the appropriate EPC would have the ability to use the allocation method currently used in all classes trading on Hybrid. When a market participant is quoting alone at the disseminated CBOE BBO and is not subsequently matched in the quote by other market participants prior to execution, it would be entitled to receive incoming electronic order(s) up to the size of its quote. In this respect, market participants quoting alone at the BBO have priority. When more than one market participant is quoting at the BBO, inbound electronic orders shall be allocated pursuant to UMA. UMA rewards market participants quoting at the best price with allocations of incoming orders. The UMA formula is a weighted average consisting of two components, one based on the number of participants quoting at the best price (Component A), and the second based on the relative size of each participant's quote (Component B), as described below.

Component A: This is the parity component of UMA. In this component, UMA treats as equal all market participants quoting at the relevant best bid or best offer (or both). Accordingly, the percentage used for Component A is an equal percentage, derived by

²⁰ See proposed CBOE Rule 6.45B(a)(i)(2)(D).

dividing 100 by the number of market participants quoting at the best price. For instance, if there are four (4) market participants quoting at the best price, each is assigned 25% for Component A (or $100/4$). This component rewards and incents market participants that quote at a better price than do their counterparts even if they quote for a smaller size.

Component B: This size prorata component is designed to reward and incent market participants to quote with size. As such, the percentage used for Component B of the Allocation Algorithm formula is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote. For example, if the disseminated quote represents the quotes of market makers X, Y, and Z who quote for 20, 30, and 50 contracts respectively, then the percentages assigned under Component B are 20% for X, 30% for Y, and 50% for Z.

Final Weighting: The final weighting, which shall be determined by the appropriate EPC, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Initially, the weighting of Components A and B shall be equal, represented mathematically by the formula: $((\text{Component A Percentage} + \text{Component B Percentage})/2) * \text{incoming order size}$.

Under current CBOE Rule 6.45A, the appropriate index floor procedures committee has the ability, for index options and options on ETFs, to vary the weights of Components A and B on a product by product basis.²¹ Proposed CBOE Rule 6.45B retains this flexibility. All other

²¹ The Exchange proposes to delete this section from current CBOE Rule 6.45A and move it to CBOE Rule 6.45B.

aspects of the UMA methodology remain unchanged, with the exception of the participation entitlement, as described below.

Currently, the appropriate committee establishes the participation entitlement methodology, which generally must be either: the entitlement percentage established by CBOE Rule 8.87 or the greater of the DPM's (or e-DPM's) UMA share or the amount the DPM/e-DPM would be entitled to by virtue of CBOE Rule 8.87.²² The Exchange proposes in CBOE Rule 6.45B(a)(ii)(C) to retain this provision (simply adding references to LMMs) and to add a third alternative, which would allow the Exchange to not award a participation entitlement.²³ In this regard, proposed paragraph (a)(ii)(C) incorporates this change by stating that the amount of the DPM's (or LMM's or e-DPM's) entitlement would be equal to the amount it otherwise would receive by virtue of the operation of UMA. Aside from this change, the proposed participation entitlement as it relates to the allocation of incoming electronic orders pursuant to UMA would operate the same as it does today.

B. Allocation of Orders in Open Outcry

With respect to the allocation of orders in the trading crowd, proposed CBOE Rule 6.45B(b) would govern. This rule is substantially similar to current CBOE Rule 6.45A(b). The section "Allocation of Orders Represented in the Trading Crowd" provides two alternative methods for allocating trades occurring in open outcry depending on whether there are any

²² See current CBOE Rule 6.45A(a)(i)(C).

²³ The Exchange also amends the references to CBOE Rule 8.87 to include references to new CBOE Rule 8.15B. As such, CBOE Rule 8.87 will govern participation entitlements for DPMs and e-DPMs while new CBOE Rule 8.15B will govern participation entitlements for LMMs. CBOE Rule 8.15B is discussed in greater detail supra.

broker-dealer ("BD") orders in the book.²⁴ If there are no BD orders in the book when the trade occurs in open outcry, allocation would be as it is today (i.e., first to respond may take 100%). If, however, there are BD orders in the book, the rule provides an alternative allocation mode. The first person to respond in open outcry would be entitled to take up to 70% of the order, the second person to respond may take 70% of the balance, and all others who responded (including those in the book) shall participate in the remainder of the order pursuant to the UMA allocation methodology, as is currently the case. Throughout both methods, public customers have absolute priority.

The CBOE Hybrid System would continue to utilize the exception to the general priority rules for complex orders in index products. As such, the Exchange proposes to incorporate the existing provision contained in CBOE Rule 6.45(e) and 6.45A(b)(iii). Under this rule, a member holding a spread, straddle, or combination order (or a stock-option order or security future-option order as defined in CBOE Rule 1.1(ii)(b) and CBOE Rule 1.1(zz)(b), respectively) and bidding (offering) on a net debit or credit basis (in a multiple of the minimum increment) may execute the order with another member without giving priority to equivalent bids (offers) in the trading crowd or in the electronic book provided at least one leg of the order betters the corresponding bid (offer) in the book. Stock-option orders and security future-option orders, as defined in CBOE Rule 1.1(ii)(a) and CBOE Rule 1.1(zz)(a), respectively, have priority over bids (offers) of the trading crowd but not over bids (offers) of public customers in the limit order book.

²⁴ A broker-dealer order is an order for the account of a non-public customer broker-dealer.

C. Interaction of Market Participant's Quotes/Orders with Orders in the Electronic Book

The Exchange proposes to adopt CBOE Rule 6.45B(c) to govern the interaction of market participants' quotes or orders with orders in the book. This rule, with minor modifications, operates in the same manner as does existing CBOE Rule 6.45A(c), which governs the allocation of orders resting in the Exchange's electronic book ("book" or "Ebook") among market participants. Generally, under the existing rule, if only one market participant interacts with the order in the book, he/she would be entitled to full priority. If, however, more than one market participant attempts to interact with the same order in the book, a "quote trigger" process initiates. Under the quote trigger process, the first market participant to interact with the book order starts a counting period lasting N-seconds whereby each market participant that submits an order within that "N-second period" becomes part of the "N-second group" and is entitled to share in the allocation of that order via the formula contained in the rule.

The Exchange proposes minor modifications to the operation of the current rule. First, the second paragraph of proposed section (c) provides that if the appropriate EPC has determined that the allocation of incoming electronic orders shall be pursuant to price-time priority as described in CBOE Rule 6.45B(a)(i), then the allocation of orders in the Electronic Book pursuant to paragraph (c) must also be based on time-priority (i.e., allocated to the first market participant to interact with the order in the book, up to the size of that market participant's order). In all other instances (i.e., when pro-rata priority or UMA is in effect), the allocation of the book order would be as it is today (i.e., allocation via the "N-second group").

Second, whereas the N-second timer must be uniform across equity classes, this proposed rule allows for different durations on a class-by-class basis. The sizes of index option trading

crowds vary considerably, from perhaps five traders in a less-active class to more than one hundred traders in options on the S&P 500 ("SPX"). The Exchange states that a 5-second timer in the SPX could result in numerous traders executing against the same order, which could mean very small allocations and rounding nightmares. The ability to vary the timer would allow the EPC to set a considerably shorter time-period. The Exchange states that, as with equities, changes to the timers would be announced to the membership via Regulatory Circular.

D. Interaction of Market Participants' Quotes

The Exchange also proposes to adopt CBOE Rule 6.45B(d) governing the interaction of quotes when they are locked. Because Hybrid allows for the simultaneous entry of quotes by multiple market participants, there would be instances in which quotes from competing market participants become locked. Currently, CBOE Rule 6.45A(d) provides that when the quotes of two market participants interact (i.e., "quote lock"), either party has one (1) second during which it may move its quote without obligation to trade with the other party. If, however, the quotes remain locked at the conclusion of one second, the quotes trade in full against each other. Proposed CBOE Rule 6.45B(d) is based on the equity rule (CBOE Rule 6.45A(d)) with one modification relating to the length of the timer. The proposal allows the appropriate EPC to vary by product the length of the quote lock timer provided it does not exceed one (1) second.²⁵ The ability to vary the timer by product is more important in an index setting where there are larger trading crowds than there are in an equity setting. In the event the appropriate committee determines to eliminate the timer (i.e., set it to zero seconds), the Exchange would not be required to send out the quote update notification otherwise required in paragraph (d)(i)(B).

²⁵ Equity classes utilize a one-second timer across-the-board.

Additionally, the Exchange proposes to amend paragraph (e) to CBOE Rule 6.45A in order to remove references to expired dates. Finally, the Exchange removes reference to the listing of index options and options on ETFs, as this would now be addressed in the introductory paragraph of proposed CBOE Rule 6.45B.

V. Other Changes

A. HOSS: CBOE Rule 6.2B

The Exchange proposes to amend certain aspects of its opening rule, CBOE Rule 6.2B, Hybrid Opening System ("HOSS"). HOSS establishes opening procedures and, today, only applies in classes in which there are DPMs. The changes proposed herein would allow HOSS to be utilized in classes in which there is either an LMM, DPM, or neither.

The first change, to paragraph (a), provides that HOSS would accept orders and quotes for a period of time prior to 8:30 a.m. Central Time. The absence of an underlying security for index options necessitates this change. Similarly, the second change to paragraph (a) allows the opening process to begin after 8:30 a.m., as opposed to when the underlying security opens. The third change to paragraph (a) obligates the appointed LMM in the class to submit opening quotes. The purpose of this requirement is to ensure the existence of a quote so that the class may open. This is the same requirement that exists for DPMs.

The Exchange proposes to amend paragraph (b) to provide that in classes without a DPM, an expected opening price would be calculated if there is a quote from either an LMM or MM in the class. This requirement recognizes that because a class may trade without a DPM or LMM, the opening procedure would need to operate with only quotes from MMs. Similarly, the proposed change to paragraph (e) provides that HOSS would not open a class unless there is a

quote from either a MM or LMM with an appointment in the class. This is equivalent to the equities side, where a class will not open without a quote from the DPM.

B. CBOE Rules 6.1 and 6.2

The Exchange also proposes to amend Interpretation and Policy .04 to CBOE Rule 6.1 and Interpretation and Policy .01 to Rule 6.2 by inserting the term "LMM" next to every reference to DPM. As LMMs would perform essentially the same functions as DPMs, this change is necessary. The Exchange also proposes in CBOE Rule 6.2 to eliminate reference to the term "Board Broker" since there is no such person anymore.

2. Statutory Basis

The Exchange proposes to list and trade on the Exchange's Hybrid System index options and options on ETFs without a DPM pursuant to allocation models that the Commission has previously approved. For the reasons stated above, the Exchange believes that the proposed rule change, as amended, is consistent with Section 6(b) of the Act²⁶ in general, and furthers the objectives of Section 6(b)(5)²⁷ in particular, in that it is designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade and, in general, to protect investors and the public interest.

²⁶ 15 U.S.C. 78f(b).

²⁷ 15 U.S.C. 78f(b)(5).

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

The Exchange does not believe that the proposed rule change, as amended, will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

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
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2004-87 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-2004-87. 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 Room. 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-2004-87 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.²⁸

Margaret H. McFarland
Deputy Secretary

²⁸ 17 CFR 200.30-3(a)(12).