

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51684; File No. SR-CBOE-2005-24)

May 11, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change Relating to the Assignment of RAES Orders to Logged-In Market-Makers Participating on RAES

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 March 15, 2005, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to add an alternative to the current procedures that apply to the assignment of orders on the Exchange’s Retail Automatic Execution System (“RAES”) to CBOE market-makers logged on to participate in RAES. The text of the proposed rule change is set forth below. Proposed new language is in italics and proposed deletions are in brackets.

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Rule 6.8 – RAES Operations

(a) – (g) No change.

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...Interpretations and Policies:

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

.01 - .05 No change.

.06 (a) In the exercise of their authority to determine the procedure for assigning RAES-eligible orders to Participating Market-Makers for execution, the appropriate FPCs have determined that in the absence of any specified alternative assignment methodology, an assigned Participating Market-Maker is required to buy/sell the entirety of each RAES order assigned to him up to the maximum size of RAES-eligible orders in that class of options. Alternatively, the appropriate FPC may specify that some or all options classes are subject to “Variable RAES”, [or to] the “100 Spoke RAES Wheel”, or with respect to index option classes only, the “1000 Spoke RAES Wheel”. Other than immediately after the Commission initially approves the Exchange to use Variable RAES (in which case Variable RAES may be implemented without the requisite notice), any time the appropriate FPC intends to discuss an issue related to the RAES allocation method the FPC must provide at least three days’ advance notice to the Exchange’s membership and must provide members with either the opportunity to provide written comments or the opportunity to appear at the meeting, or both regarding the proposed change.

(b) No change.

(c) Under the “100 Spoke RAES Wheel,” RAES orders would be assigned to logged-in market makers [according to] based on the percentage of their in-person agency contracts traded in that class (excluding RAES contracts traded) compared to all of the market-maker in-person agency contracts traded (excluding RAES contracts) during the review period. The review period will be determined by the appropriate Floor Procedure Committee and may be for any period not in excess of 10 trading days within the previous 30 calendar days. The trading days within the review period may be for non-consecutive trading days. The percentage distribution will be calculated at the conclusion of each trading day and will be applied to the 100 Spoke

RAES Wheel distribution on the following trading day. On each revolution of the RAES wheel, subject to the exceptions described below, each participating market-maker (who is logged onto RAES at the time) will be assigned enough contracts to replicate his percentage of contracts on RAES that he traded in-person in that class during the review period. A participation percentage will be calculated for each market-maker for each class that the market-maker trades. For this purpose all DPM Designees of the same DPM unit will have their percentage aggregated into a single percentage for the DPM unit.

Once a market-maker has logged onto RAES, he will be assigned contracts on the RAES Wheel until his market-maker participation percentage has been met. This may mean that multiple orders (or an order and a part of the succeeding order) will be assigned to the same market-maker on the Wheel. To understand how the RAES orders will actually be allocated to market-makers to meet those percentages, one must understand the concepts of “spokes” and “wedges.” A “spoke” is 1% of the RAES wheel and often may be equal to one contract. The appropriate Floor Procedure Committee may determine the number of contracts that make up one spoke. Each market-maker logged onto RAES for that class, regardless of his participation percentage, is entitled to be assigned at least one spoke on every revolution of the RAES wheel. For example, if a spoke equals one contract then there will be 100 [spokes] contracts that will be assigned to market-makers on every revolution of the RAES wheel. If a spoke is defined as five contracts then there will be 500 RAES contracts assigned to the participating market-makers before the RAES wheel completes one revolution. Generally, the RAES Wheel will consist of the number of spokes replicating the cumulative percentage of all market-makers logged onto the system who have a participation percentage plus one spoke for each market-maker that does not have a specific participation percentage.

A “wedge” is the maximum number of spokes that a market-maker may be consecutively assigned at any one time on the RAES wheel. Because the size of the wedge may be smaller than the number of contracts to which a particular market-maker is entitled during one revolution of the RAES Wheel, that market-maker will receive more than one turn during one revolution of the RAES wheel. The wedge size will be variable, at the discretion of the appropriate Floor Procedure Committee and may be different for different classes or the same for all classes. The appropriate Floor Procedure Committee will notify the membership of each class of options that is subject to the “100 Spoke RAES Wheel”.

(d) Under the “1000 Spoke RAES Wheel”, which may only be implemented in index option classes, all of the terms and provisions set forth in CBOE Rule 6.8.06(c) with respect to the 100 Spoke RAES Wheel shall apply to the 1000 Spoke RAES Wheel, except that (i) the 1000 Spoke RAES Wheel is comprised of 1000 spokes, each of which generally represents .1% of the 1000 Spoke RAES Wheel, and (ii) the appropriate Floor Procedure Committee shall determine on a class by class basis whether the assignment of RAES orders to logged-in Market-Makers is based on the percentage of a Market-Maker’s contracts traded in that index option class (excluding RAES contracts traded) compared to all Market-Maker contracts traded (excluding RAES contracts) during the review period, or the percentage of the Market-Maker’s in-person agency contracts traded in that class (excluding RAES contracts traded) compared to all Market-Maker in-person agency contracts traded (excluding RAES contracts) during the review period.

The appropriate Floor Procedure Committee will notify the membership of each class of options that is subject to the “1000 Spoke RAES Wheel” and the method of allocation for RAES orders under the 1000 Spoke RAES Wheel.

([d] e) The effectiveness of any other methodology for assigning RAES orders to Participating Market-Makers that may be adopted by an appropriate FPC shall be conditioned upon its having been filed with the Securities and Exchange Commission pursuant to Section 19(b) of the Securities Exchange Act of 1934.

.07 - .09 No change.

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

In its filing with the Commission, CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

CBOE Rule 6.8 – RAES Operations – governs the execution of orders on RAES. CBOE Rule 6.8.06 sets forth alternatives available to the appropriate Floor Procedure Committee to implement the procedures for the assignment of RAES-eligible orders to CBOE market-makers logged on to RAES for execution. One alternative set forth in current Rule 6.8.06(c), the “100 Spoke RAES Wheel,” assigns RAES orders to logged-in market-makers based on the percentage of their in-person agency contracts traded in that class (excluding RAES contracts traded) compared to all of the market-maker in-person agency contracts traded (excluding RAES

contracts) during the review period.³ The proposed rule change sets forth a new alternative, available only in index option classes, that offers a wheel with 1000 spokes and assignment procedures that are similar to the assignment procedures applicable to the 100 Spoke RAES Wheel.

Under the proposed 1000 Spoke RAES Wheel, the appropriate Floor Procedure Committee will determine on a class-by-class basis whether the assignment of RAES orders to logged-in market-makers is based on the percentage of a market-maker's contracts traded in that index option class (excluding RAES contracts traded) compared to all market-maker contracts traded (excluding RAES contracts) during the review period, or the percentage of the market-maker's in-person agency contracts traded in that class (excluding RAES contracts traded) compared to all market-maker in-person agency contracts traded (excluding RAES contracts) during the review period. As is the case with the 100 Spoke RAES Wheel, the procedure for the 1000 Spoke RAES Wheel would provide that on each revolution of the wheel, each participating market-maker who is logged in RAES at the time will be assigned a number of contracts that

³ As stated in CBOE Rule 6.8.06(c), the review period will be determined by the appropriate Floor Procedure Committee and may be for any period not in excess of 10 trading days within the previous 30 calendar days. The trading days within the review period may be for non-consecutive trading days. According to CBOE, the review period is re-determined, and thus participation percentages are re-calculated, on a daily basis. Thus, CBOE notes that while a new market-maker is entitled to be assigned at least one spoke on every revolution of the RAES wheel, the market-maker would on subsequent days be entitled to replicate the percentage of non-RAES contracts that he actually traded during the relevant review period. For example, if a new market-maker signs onto RAES and is allocated one spoke, but the market-maker trades enough non-RAES contracts on that day to qualify the market-maker for more than one spoke when the review period is re-determined on the following day, the market-maker would be entitled to such additional spoke or spokes. Telephone conferences between David M. Doherty, Assistant Secretary, CBOE, and Geoffrey C. Pemble, Special Counsel, Division of Market Regulation, Securities and Exchange Commission, on April 6, 2005 and between Mr. Doherty and David L. Orlic, Attorney, Division of Market Regulation, Securities and Exchange Commission, on April 22, 2005.

approximates the percentage of contracts on RAES that he or she traded in-person in that index option class during the review period, subject to the restrictions set forth in current Rule 6.8.06(c).

The effect of utilizing the 1000 Spoke RAES Wheel instead of the 100 Spoke RAES Wheel is that the number of contracts allocated to a market-maker will increase by a factor of 10 for every revolution of the RAES wheel. This procedure is designed to reduce the rounding effects that result under the 100 Spoke RAES Wheel (the RAES system configuration rounds contracts to the nearest whole number). For example, if the percentage of a market maker's contracts traded in an index option class compared to all of the market-maker in person contracts traded during the review period is 1.34%, the 100 Spoke RAES Wheel would allocate 1 contract to the market-maker for every revolution of the RAES wheel. In contrast, the 1000 Spoke RAES Wheel would allocate 13 contracts to the market-maker (13.4 contracts, rounded to the nearest whole number) for every revolution.

Allocation Example

To better understand how RAES contracts would be assigned under the "1000 Spoke RAES Wheel," the table below shows the allocations a market-maker would receive under each

of the “100 Spoke RAES Wheel” and “1000 Spoke RAES Wheel.” The example assumes that one spoke on the 1000 Spoke RAES Wheel is equivalent to one contract.⁴

Market-Maker	Percent of Market-Maker Non-RAES Volume	Number of Contracts Based on a 100 Spoke Wheel	Number of Contracts Based on 1000 Spoke Wheel
1	37.90	38	379
2	30.40	30	304
3	9.90	10	99
4	4.49	4	45
5	2.90	3	29
6	1.25	1	13
7	1.40	1	14
8	0.85	1	9
9	0.90	1	9
10	0.00	1	1
Totals		90	902

The table set forth above demonstrates that the 1000 Spoke RAES Wheel more closely approximates a market-maker’s participation percentage. The allocation of 902 contracts in the 1000 Spoke RAES Wheel also highlights the fluctuation of the RAES wheel size resulting from the rounding effects and the inclusion of new market-makers who do not have a participation percentage in the wheel.

The Exchange notes that the operation of the “wedge” allocation, which establishes the maximum number of spokes that a market-maker may be consecutively assigned at any one time

⁴ Normally, one spoke on the wheel will be equivalent to one contract, except that the appropriate Floor Procedure Committee may establish a larger spoke size. Changing the spoke size (and thus, the wheel size) does not change the participation percentages of the individual market-makers. Each market-maker logged on to RAES is entitled to at least one spoke on every revolution of the wheel, regardless of what might otherwise be his entitlement based on his participation during the review period. This ensures that new market-makers logged on to RAES have a minimum participation in RAES transactions. These procedures are identical to the procedures governing the allocation of trades under the 100 Spoke RAES Wheel.

on the wheel, would limit consecutive distributions to any one market-maker. A wedge is the maximum number of spokes that may be assigned to a market-maker in any one “hit” during a rotation of the RAES Wheel. The concept of the wedge system ensures that each market-maker eligible to participate during a particular review period will be assigned at least some contracts before market-makers entitled to a greater number of spokes are assigned all of their contracts in a given revolution. The wedge system also breaks up the distribution of contracts into smaller groupings in order to reduce exposure of any one market-maker to market risk. If the size of the wedge is smaller than the number of spokes to which a particular market-maker may be entitled based on his participation percentage, the market-maker will be assigned more than once during one revolution of the RAES Wheel. For example, in the table above, where one spoke on the 1000 Spoke RAES Wheel is equal to one contract, MM7 would receive a total of 14 contracts during one revolution of the RAES Wheel. If the wedge size is 10, MM7 will first be assigned 10 contracts on the RAES Wheel and then 4 contracts at a different place on the RAES Wheel during that same revolution. Thus, in one complete revolution of the RAES Wheel, he will be assigned two times for a total of 14 contracts, consisting of one 10-contract assignment and one 4-contract assignment. As set forth in current Rule 6.8.06(c), which rule would govern the 1000 Spoke RAES Wheel, the wedge size will be variable at the discretion of the appropriate Floor Procedure Committee and may be different for different index classes or the same for all index classes.

The proposed rule changes also propose to revise the type of trades that could be included in the percentage allocation under the 1000 Spoke RAES Wheel. Specifically, the proposed rule would permit the appropriate Floor Procedure Committee to determine on a class by class basis whether the assignment of RAES orders to logged-in market-makers is based on the percentage

of a market-maker's contracts traded in that index option class (excluding RAES contracts traded) compared to all of the market-maker contracts traded (excluding RAES contracts) during the review period, or the percentage of the market-maker's in-person agency contracts traded in that class (excluding RAES contracts traded) compared to all of the market-maker in-person agency contracts traded (excluding RAES contracts) during the review period. The purpose of this proposed change is to recognize the trading dynamics that exist in index option trading crowds where trading between market makers is more prevalent.⁵ Other than the proposed changes described above, all other terms and provisions that apply to the 100 Spoke RAES Wheel as provided in CBOE Rule 6.8.06(c) would apply to the 1000 Spoke RAES Wheel.

Lastly, the Exchange is revising CBOE Rule 6.8.06(c) to make clarifying changes to the description of the operation of the 100 Spoke RAES Wheel.

The Exchange believes the proposed 1000 Spoke RAES Wheel will provide a viable alternative to the 100 Spoke RAES Wheel, which was used in some equity option trading crowds prior to the transfer of equity option trading to the Exchange's Hybrid system. The Exchange developed the 100 Spoke RAES Wheel to better distribute RAES volume to those market-makers providing greater liquidity in the trading pits. However, index floor procedure committees have not employed the 100 Spoke RAES Wheel alternative because of the rounding effects that would occur in large trading crowds.⁶ Specifically, as the trading crowds increase, the percentage allocation becomes more widely dispersed among the many market-makers in index trading crowds. The rounding requirements could erode allocations even further for

⁵ Telephone conversation between David M. Doherty, Assistant Secretary, CBOE, and David L. Orlic, Attorney, Division of Market Regulation, Securities and Exchange Commission, on April 22, 2005.

⁶ Telephone conversation between David M. Doherty, Assistant Secretary, CBOE, and David L. Orlic, Attorney, Division of Market Regulation, Securities and Exchange Commission, on April 22, 2005.

market-makers with small percentage allocations, which would occur on a more frequent basis as the size of the crowd increases. The Exchange believes the 1000 Spoke RAES Wheel would diminish this effect, while at the same time preserving the distribution benefits to those market-makers providing greater liquidity in index trading pits.

2. Statutory Basis

CBOE believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.⁷ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)⁸ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest. CBOE believes that the proposed rule change will enhance the ability of the Exchange to provide instantaneous automatic execution of public customer orders at the best available prices in index option classes.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition 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

The Exchange did not solicit or receive any written comments with respect to the proposed rule change.

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve the proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

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-2005-24 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-2005-24. 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 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-2005-24 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.⁹

J. Lynn Taylor
Assistant Secretary

⁹ 17 CFR 200.30-3(a)(12).