

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51822; File No. SR-CBOE-2004-87)

June 10, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Accelerated Approval of a Proposed Rule Change and Amendment Nos. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto Relating to Trading Rules on the Hybrid System for Index Options and Options on ETFs

I. Introduction

On December 17, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to 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"). The CBOE filed Amendment Nos. 1 and 2 to the proposed rule change on March 23, 2005³ and April 26, 2005,⁴ respectively. The proposed rule change, as amended by Amendment Nos. 1 and 2, was published for comment in the Federal Register on May 17, 2005.⁵ The Commission received no comments on the proposal.

On June 3, 2005, the CBOE filed Amendment No. 3 to the proposed rule change.⁶ This order grants accelerated approval the proposed rule change, as amended by Amendment Nos. 1

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³ Amendment No. 1 replaced and superseded the originally filed proposed rule change.

⁴ Amendment No. 2 replaced and superseded the originally filed proposed rule change and Amendment No. 1.

⁵ See Securities Exchange Act Release No. 51680 (May 10, 2005), 70 FR 28326.

⁶ Amendment No. 3 amended note 7 in Item 3 of Form 19b-4 of Amendment No. 2 and the parallel reference in Exhibit 1 to Amendment No. 2 to delete the reference to Satisfaction Orders and made two technical corrections to the proposed rule text.

and 2. Simultaneously, the Commission is providing notice of filing of Amendment No. 3 and granting accelerated approval of Amendment No. 3.

II. Description

The Exchange currently trades equity options, index options, and options on exchange-traded funds ("ETFs") on its Hybrid Trading System ("Hybrid"), which is an options trading platform that combines the features of electronic and open outcry, auction market principles, while, at the same time, providing market makers the ability to electronically stream their own quotes. 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 assigned DPM. The Exchange proposes to extend the Hybrid trading rules that currently apply to classes of equity options ("equity classes") to classes of index options and options on ETFs (collectively, "index classes") without an assigned DPM, with some proposed rule modifications. In this regard, the proposal would allow the trading of these index classes on Hybrid either with a DPM, LMM, or without a DPM or LMM in classes where there are a requisite number of assigned MMs.

To implement this proposal, the Exchange proposes to adopt several new rules (most notably CBOE Rules 6.45B, 8.14, 8.15, and 8.15B), and to amend several existing rules (i.e., CBOE Rules 6.1, 6.2, 6.2B, 6.45A, 7.4, and 8.15). New CBOE Rule 6.45B would contain the rules pertaining to priority and allocation of trades for index classes, while existing CBOE Rule 6.45A would be amended to apply solely to equity options. New proposed CBOE Rule 8.14 describes the market maker participants permissible for index classes trading in Hybrid. New proposed CBOE Rule 8.15A contains provisions relating to LMMs in Hybrid classes, while existing CBOE Rule 8.15 would be amended to apply to LMMs in non-Hybrid

classes. Finally, new proposed CBOE Rule 8.15B describes the participation entitlement applicable to LMMs. A more complete description of the proposal, as amended, is provided in Section IV, below.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 3 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, 100 F Street, NE, Washington, DC 20549-9303.

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 the

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].

IV. Commission's Findings and Order Granting Accelerated Approval of Amendment No. 3 and Accelerated Approval of Proposed Rule Change, As Amended

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁷ and, in particular, the requirements of Section 6(b) of the Act.⁸ Specifically, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act⁹ in that it is designed to facilitate transactions in securities, to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade and, in general, to protect investors and the public interest.

A. Trading Without a DPM or LMM

The Exchange proposes to adopt new CBOE Rule 8.14 to specify the permitted categories of market participants in index classes. The proposed rule would allow 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 classes. Additionally, the appropriate EPC would determine the eligible categories of

⁷ In approving this proposed rule change, as amended, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation.

15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

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.¹⁰

Proposed paragraph (b) of CBOE Rule 8.14 would provide 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).¹¹ 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:¹²

- 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) 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

¹⁰ CBOE Rule 8.1 provides that the term "Market-Maker" includes Remote Market-Makers, as defined in CBOE Rule 8.4.

¹¹ CBOE Rule 8.7(d) governs the quoting obligations for MMs in Hybrid classes.

¹² These requirements are based on similar requirements contained in CBOE Rule 44.4(b).

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 to 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.

The Commission believes that the proposed rules governing trading without a DPM or LMM are consistent with the Act. In addition, the Commission notes that the current proposal does not permit the Exchange to allow a multiply-listed product to trade without a DPM or LMM unless the Exchange submits a new proposed rule change to the Commission (and receives Commission approval thereof) relating to its market maker obligation rules indicating how such orders would be submitted to other exchanges on behalf of market makers in accordance with the Intermarket Options Linkage Plan requirements.

B. 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 proposed CBOE Rule 8.15A, Lead Market Makers in Hybrid Classes, which mimics current

CBOE Rule 8.15 with few changes.¹³ 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 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

¹³ The Exchange proposes to amend CBOE Rule 8.15 to limit its application to non-Hybrid classes.

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 Plan. 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. Under the proposal, LMMs and Order Book Officials ("OBOs") would handle linkage functions for classes without a DPM. OBOs would represent inbound linkage orders 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.¹⁴ 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 the P/A orders.¹⁵

The Exchange proposes to make a corresponding change to CBOE Rule 7.4(a)(2) to permit OBOs to receive Linkage orders from other exchanges that are participants in the

¹⁴ See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (Aug. 4, 2000) (order approving the Options Intermarket Linkage Plan).

¹⁵ See Amendment No. 3, supra note 6.

Intermarket Options Linkage Plan.¹⁶ 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 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 change would provide 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.¹⁷ With respect to handling inbound linkage orders, OBOs would handle only those orders that do not automatically execute via the Exchange's systems.

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.¹⁸ 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. 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

¹⁶ 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.

¹⁷ All linkage fees incurred for routing P/A orders for the benefit of underlying orders would be borne by the LMM.

¹⁸ CBOE Rule 8.15(b)(2).

CBOE Rule 8.51 to be firm. In a Hybrid system, each MM posts its own quotes; hence, there is no need for MMs to know which variables an LMM uses in its pricing calculation.

The Commission believes that the proposed rules regarding LMM obligations are consistent with the Act. In particular, the Commission believes that the proposed use of the OBO, together with the proposed agency responsibility of the LMM in handling P/A and Satisfaction orders, should ensure that these orders will be handled properly in accordance with the Intermarket Options Linkage Plan.

C. LMM Participation Entitlement

Today, LMMs do not receive participation entitlements nor does CBOE Rule 8.87 address granting a participation entitlement to LMMs. The Exchange proposes to adopt new proposed 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 ("MPC") 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.¹⁹

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

¹⁹ 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.

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.²⁰

Finally, proposed paragraph (c) also allows the appropriate MPC to determine, on a class-by-class basis, to decrease the LMM participation entitlement percentages from the percentages specified in paragraph (c). 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, it will submit a "regular-way" rule filing to the Commission.

The Commission believes that the proposed rules governing LMM participation entitlements are consistent with the Act. The Commission believes that, under the proposed new rules, LMMs would have many of the same functions and obligations as DPMs and e-DPMs, both of which receive participation entitlements, and therefore, it would be reasonable for LMMs to receive a participation entitlement not to exceed the percentage previously approved by the Commission. The Commission also believes that it is reasonable for the MPC to have discretion to decrease the participation entitlement for a given index class after advance notice has been

²⁰ A single LMM would function in any given class at one time, though there may be several LMMs approved in such class. Should more than one LMM function in a given class at the same time, the Exchange would need to file a proposed rule change with the Commission to address potential rule changes required in such a situation (e.g., how linkage orders would be handled). Telephone conversation between David Doherty, Attorney II, CBOE and David Liu, Attorney, Division of Market Regulation, Commission, on June 8, 2005.

given via Regulatory Circular to the membership. The Commission emphasizes that the CBOE must submit a proposed rule change to the Commission if it seeks to increase the LMM participation entitlement beyond the 30/40/50 percent entitlement.

D. Allocation of Trades

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

1. 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. 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"). 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.

a. 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

by class basis, adopt either a price-time or pro-rata allocation model.²¹ 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 priority²² or participation entitlement priority.²³ 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.

²¹ See CBOE Rule 43.1(a)(1) (price-time priority) and (a)(2) (pro rata priority). The International Stock Exchange, Inc. ("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).

²² 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.

²³ 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.²⁴

b. 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 dividing 100 by the number of market participants quoting at the best price. For instance,

²⁴ See proposed CBOE Rule 6.45B(a)(i)(2)(D).

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 classes, to vary the weights of Components A and B on a product by product basis.²⁵ Proposed CBOE Rule 6.45B retains this flexibility. All other 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

²⁵ The Exchange proposes to delete this section from current CBOE Rule 6.45A and move it to CBOE Rule 6.45B.

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 8.87.²⁶ 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.²⁷ 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 Exchange has represented that 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.

The Commission believes that the proposed rules regarding allocation of incoming electronic orders are consistent with the Act. The Commission notes that the allocation provisions are based on rules currently in place at the Exchange, including current rules relating to SBT and UMA. The Commission notes that the CBOE believes that providing the EPC with the ability to determine which allocation methodology is best for a given index class should be appropriate because the EPC should have the best familiarity with the product and its trading dynamics, which should allow it to determine which allocation methodology is most appropriate for it. In addition, the Commission believes that the proposed allocation algorithms should provide incentives to quote competitively by providing market participants with the ability to independently submit their quotes and then rewarding the market participants that quote at the

²⁶ See current CBOE Rule 6.45A(a)(i)(C).

²⁷ 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.

best price with an allocation of the resulting trade. The Commission also expects the Exchange to ensure compliance with the requirements of Section 11(a) of the Act.²⁸

2. 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 broker-dealer ("BD") orders in the book.²⁹ 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 Rules 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

²⁸ 15 U.S.C. 78k(a).

²⁹ A broker-dealer order is an order for the account of a non-public customer broker-dealer.

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.

The Commission believes that the proposed rules governing allocation of orders represented in open outcry are consistent with the Act. The Commission also expects the CBOE to comply with the requirements of Section 11(a) of the Act³⁰ in dealing with the allocation of orders in open outcry.

3. 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.

³⁰ 15 U.S.C. 78k(a).

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.

The Commission believes that this algorithm, which is similar to the algorithm adopted for the Exchange's equity classes, is consistent with the Act, and should ensure that additional market participants have an opportunity to interact with orders resting on the Exchange's electronic book. The Commission also notes that, given that the sizes of index option trading crowds vary considerably, the Exchange provides flexibility and discretion to its EPC to set, on a class by class basis for index classes, a shorter time period than the 5-second timer applicable to

equity classes. The Commission also notes that any changes to the N-second interval would be announced to the CBOE membership in advance of implementation.

4. 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 (1) 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.³¹ 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).

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.

³¹ Equity classes utilize a one-second timer across-the-board.

The Commission notes that the proposed provisions regarding locked quotes are substantially similar to provisions previously approved by the Commission. The Commission believes that the proposed provisions are consistent with the Quote Rule.³² Market makers would continue to be required to honor their quotes and thus would be obligated to execute incoming orders pursuant to CBOE Rule 6.13. In addition, the Commission believes that the proposed "counting period" provides a reasonable method for market makers that lock or cross a market to unlock or uncross the market, as required by the Intermarket Options Linkage Plan. Moreover, during the "counting period," the market makers whose quotes are locked would remain obligated to execute customer and broker-dealer orders eligible for automatic execution at the locked price.³³

E. Other Changes

1. 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 a DPM, LMM, or neither.

First, the Exchange proposes to amend paragraph (a) of CBOE Rule 6.2B to provide 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

³² 17 CFR 240.11Ac1-1.

³³ See Proposed CBOE Rule 6.45B(d).

existence of a quote so that the class may open. This is the same requirement that exists for DPMs.

The Exchange also proposes to amend paragraph (b) of CBOE Rule 6.2 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) of CBOE Rule 6.2 B 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.

The Commission believes that the proposed rule changes are consistent with the Act to ensure that: (1) an opening price is calculated if a class trades without a DPM or LMM; (2) a class will not be opened on HOSS (i) without a quote from the DPM, in classes which a DPM has been appointed; and (ii) when there is no quote from at least one MM or LMM with an appointment in the class, in classes in which no DPM has been appointed.

2. CBOE Rules 6.1 and 6.2

The Exchange also proposes to amend Interpretation and Policy .05 to CBOE Rule 6.1³⁴ 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.

³⁴ See Amendment No. 3, supra note 6.

The Commission believes that these proposed rule changes are also consistent with the Act.

F. Accelerated Approval of Amendment No. 3 and the Proposed Rule Change and Amendment Nos. 1 and 2 Thereto

In Amendment No. 3, the Exchange proposes to: (1) clarify that linkage fees do not apply to Satisfaction orders; (2) change the reference from CBOE Rule 6.1, Interpretation .04 to CBOE Rule 6.1, Interpretation .05 to more accurately reflect the proposed rule text; and (3) insert in the proposed rule text the reference to CBOE Rule 6.45A(c)(ii)(A) that the CBOE inadvertently left out of the proposed rule text. The Commission notes that the changes contained in Amendment No. 3 are non-substantive in nature and are necessary to clarify the proposal, as well as to correct technical omissions in the proposed new rules.³⁵ Accordingly, the Commission finds that there is good cause, consistent with Section 6(b)(5)³⁶ and Section 19(b)(2) of the Act,³⁷ to approve Amendment No. 3 on an accelerated basis prior to the 30th day after the date of publication of notice of filing thereof in the Federal Register.

Pursuant to Section 19(b)(2) of the Act,³⁸ the Commission may not approve any proposed rule change prior to the thirtieth day after the date of publication of the notice of filing thereof, unless the Commission finds good cause for so finding. The Commission hereby finds good cause for approving the proposed rule change prior to the 30th day after publishing notice thereof in the Federal Register. The Commission notes that the proposed rule change, as amended, has been subject to a full notice and comment period, and that no comments have been received.

³⁵ See Amendment No. 3, supra note 6.

³⁶ 15 U.S.C. 78f(b)(5).

³⁷ 15 U.S.C. 78s(b)(2).

³⁸ 15 U.S.C. 78s(b)(2).

By permitting the Exchange to trade index classes on Hybrid without an assigned DPM, the Exchange will have the flexibility to trade index classes on Hybrid either with a DPM, LMM, or without a DPM or LMM in classes where there are a requisite number of assigned MMs. The Commission believes that the proposed rule change, which provides for a variety of different participants to trade index classes on Hybrid, will greatly benefit the way investors trade their index classes. Therefore, the Commission finds good cause exists to accelerate approval of the proposal, as amended, pursuant to Section 19(b)(2) of the Act.³⁹

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴⁰ that the proposed rule change (File No. SR-CBOE-2004-87), as amended by Amendment Nos. 1, 2, and 3, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴¹

Margaret H. McFarland
Deputy Secretary

³⁹

Id.

⁴⁰

15 U.S.C. 78s(b)(2).

⁴¹

17 CFR 200.30-3(a)(12).