

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52798; File No. SR-CBOE-2005-46)

November 18, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 2 and 4 Thereto Relating to the Removal of Agency Responsibilities from Designated Primary Market-Makers and the Establishment of PAR Officials

I. Introduction

On June 10, 2005, 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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its rules relating to Designated Primary Market-Makers (“DPMs”) to eliminate the DPM’s responsibility to act as agent in the options in which it is registered as the DPM on the Exchange. Instead, the Exchange has proposed to designate a CBOE employee or independent contractor (“PAR Official”) to be responsible for assuming the responsibility for handling certain orders currently undertaken by the DPMs in their allocated options classes, including the operation of the PAR workstation. The Exchange filed Amendment No. 1 with the Commission on July 1, 2005.<sup>3</sup> The amended proposal was published for comment in the Federal Register on July 19, 2005.<sup>4</sup> The Commission received one comment letter regarding the proposal.<sup>5</sup> The Exchange filed Amendment No. 2 with the Commission on

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 replaced and superceded the original rule filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 52017 (July 12, 2005), 70 FR 41453 (“Notice”).

<sup>5</sup> See email from Margaret Wiermanski, Chief Operations and Compliance Officer, CTC, LLC, dated July 29, 2005 (“CTC Letter”).

October 6, 2005.<sup>6</sup> The Exchange filed Amendment No. 3 with the Commission on November 17, 2005, and withdrew Amendment No. 3 on November 18, 2005. The Exchange filed Amendment No. 4 with the Commission on November 18, 2005.<sup>7</sup> This order approves the proposed rule change, as amended. In addition, the Commission seeks comment from interested persons on Amendments No. 2 and 4.

## II. Description of Proposed Rule

Under its current rules, a DPM is defined as a “member organization that is approved by the Exchange to function in allocated securities as a Market-Maker . . . , as a Floor Broker . . . , and as an Order Book Official . . . .”<sup>8</sup> CBOE Rule 8.85 further sets out the DPM’s obligations regarding agency transactions. According to the CBOE, its uniform practice has been to require DPMs to act as Floor Brokers for the classes of options assigned to them. Accordingly, all DPMs on CBOE presently act as both agent and principal in their allocated options on the Exchange.

The CBOE has now determined to eliminate a DPM’s agency duties, including the responsibilities associated with operating the PAR workstation. Specifically, CBOE has proposed to amend its rules to remove a DPM’s obligation to act as an agent or Floor Broker in its allocated securities on the Exchange. In a DPM’s place, the Exchange has proposed to designate a PAR Official who will be responsible for handling certain orders in the same manner

<sup>6</sup> See Partial Amendment, submitted by James Flynn, Assistant Secretary, CBOE (“Amendment No. 2”). In Amendment No. 2, CBOE proposed an additional change to CBOE Rule 6.8 to conform the text of this rule with the proposal.

<sup>7</sup> See Partial Amendment, submitted by James Flynn, Assistant Secretary, CBOE (“Amendment No. 4”). In Amendment No. 4, CBOE proposed additional changes to CBOE Rules 6.45, 6.45A, 6.45B, 8.94, and 17.50 to conform the text of these rules with the proposal.

<sup>8</sup> See CBOE Rule 8.80.

as they were formerly handled by the DPM. In particular, the PAR Official will operate the PAR workstation, maintain the public customer limit order book for its assigned non-Hybrid option classes, execute orders that are sent to the PAR workstation or that are placed on the limit order book, display eligible limit orders, and undertake the obligations related to handling certain Linkage Orders.<sup>9</sup>

The Exchange has proposed to amend its definition of “Principal Acting as Agent (‘P/A’) Order” to remove the requirement that a Market-Maker act as an agent for the unexecuted customer order related to the P/A Order.<sup>10</sup> The CBOE proposed this change to conform to its proposal to remove the DPM’s agency responsibilities. The proposed rule change also assigned certain obligations to the PAR Officials related to the handling of Linkage Orders, including using a DPM’s account to route P/A Orders, Principal Orders on behalf of orders in the custody of the PAR Official that are for the account of a broker-dealer, and Satisfaction Orders to other participants in the Linkage Plan. In addition, PAR Officials would have the obligation to handle all Linkage Orders or portions of Linkage Orders received by the Exchange that are not automatically executed, and to use the DPM’s account to fill a Satisfaction Order that results from a Trade-Through that is effected on the Exchange by a PAR Official. The proposed rule change also requires DPMs to provide prior written instructions to the PAR Officials regarding routing Linkage Orders and handling responses to Linkage Orders.

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<sup>9</sup> See infra note 10.

<sup>10</sup> The proposed rule change would amend CBOE Rule 6.80(12) to provide that “Linkage Order” means an Immediate or Cancel Order routed through the Linkage as permitted under the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (“Linkage Plan”). Amended Rule 6.80(12) would change the definition of “Principal Acting as Agent (‘P/A’) Order” to be “an order for the principal account of a Market-Maker (or equivalent entity on another Participant Exchange that is authorized to represent Customer orders) reflecting the terms of a related unexecuted Customer order.”

The CBOE has proposed measures designed to ensure the independence of PAR Officials from Exchange members. Specifically, the PAR Official would be required to be an Exchange employee or independent contractor whose compensation would be determined, and paid, solely by CBOE. Further, the PAR Official would be prohibited from having an affiliation with any CBOE member that acts as a Market-Maker on the Exchange.

Because the DPM would no longer be operating the PAR workstation, CBOE proposed to amend its Rule 8.51, which defines when a DPM's firm quote obligation attaches for orders received over PAR. Interpretation and Policy .10 to CBOE Rule 8.51 currently provides that, in the case of orders received at a PAR workstation in a DPM trading crowd, the DPM's firm quote obligation attaches at the time the order is received on the PAR workstation. CBOE has proposed to clarify that firm quote obligations attach to all responsible brokers or dealers in the trading crowd, which may include the DPM, at such time as when the PAR Official announces the order to the crowd. The Exchange has proposed this clarification in light of the fact that DPMs will no longer represent orders as Floor Broker from the instant such orders are received on the PAR workstation.

In Amendment No. 2, the Exchange has proposed to amend subsection (d)(vi) of Rule 6.8 (RAES Operations) to indicate that: (1) DPMs no longer would be responsible for handling or representing orders that are routed to a CBOE PAR workstation or to the Exchange's "Live Ammo" functionality, and (2) to the extent that a PAR Official would be taking such responsibilities, the PAR Official will be required to use his or her best efforts to attempt to ensure that members receive an allocation of any incoming orders for up to their disseminated size.

In Amendment No. 4, the Exchange has proposed to amend CBOE Rule 8.93 (e-DPM Obligations) to exclude from the e-DPM's obligations the proposed obligation of DPMs to allow a PAR Official to use the DPM's account to send and respond to linkage orders.<sup>11</sup> The Exchange represents that PAR Officials will use only DPM accounts, not e-DPM accounts, to generate linkage orders and responses as required by proposed CBOE Rule 7.12(e).<sup>12</sup> The Exchange also has proposed conforming changes to CBOE Rules 6.45 (Priority of Bids and Offers—Allocation of Trades), 6.45A (Priority and Allocation of Equity Option Trades on the CBOE Hybrid System), 6.45B (Priority and Allocation of Trades in Index Options and Options on ETFs on the CBOE Hybrid System), 8.93, and 17.50 (Imposition of Fines for Minor Rule Violations) to reflect (1) that customer orders currently represented by DPMs would be represented by PAR Officials under the proposal and (2) the proposed removal of DPMs' agency obligations under CBOE Rule 8.85(b).

The text of the changes proposed in Amendments No. 2 and 4 is available on CBOE's Web site (<http://www.cboe.org/legal/>), at CBOE's office of the secretary, and at the Commission's Public Reference Room.

### III. Summary of Comments

The Commission received one comment letter on the proposed rule change.<sup>13</sup> The commenter, a member firm of the Exchange, endorsed the proposed rule filing and agreed with its purpose and intent. However, the commenter suggested that the proposal be initially approved on a three-month pilot basis to provide the Exchange, its members, and its participants

<sup>11</sup> See Proposed CBOE Rule 8.85(a)(xiv).

<sup>12</sup> Telephone conversation between James Flynn, Assistant Secretary, CBOE, and Tim Fox, Special Counsel, and Nathan Saunders, Special Counsel, Division of Market Regulation ("Division"), Commission, on November 17, 2005.

<sup>13</sup> See CTC Letter, supra note 5.

with “some working experience” before the rule is permanently approved. The commenter wrote that certain “basic operational considerations” related to the implementation of the proposed rule change are still unknown—for example, the mechanics of how Linkage Orders will be booked into the DPM’s account by the PAR Official, and how the new procedures would affect CBOE’s membership rules and compliance by CBOE with the consolidated options audit trail system (“COATS”) regulations. The commenter suggested that a pilot period would make any required modification to the rules administratively easier to accomplish.

The CBOE responded to the commenter’s concerns related to the implementation and operation of the PAR Official program.<sup>14</sup> The CBOE emphasized the long-term goals of the PAR Official program were promoted by this filing because it would “eliminat[e] the risks associated with a DPM acting as both principal and agent . . . .” The CBOE suggested that a pilot program could “frustrate these efforts” and create “uncertainty” regarding the status of the DPM program. The Exchange also represented that it believed a better mechanism to resolve the complications that arise as a result of the proposed rule change would be for the CBOE to address the problems promptly, either through additional rule filing(s), systems enhancements, or operation modifications. In addition, the CBOE pointed out that the proposal already provides a three-month period following approval for the CBOE and its members to fully implement the PAR Official program in all DPM trading stations, which the CBOE believes should allow it to address any implementation issues that may arise as a result of the proposed rule change.

#### IV. Discussion

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

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<sup>14</sup> See Email from James Flynn, Attorney II, CBOE to Jonathan G. Katz, Secretary, Commission, dated September 1, 2005.

a national securities exchange.<sup>15</sup> In particular, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,<sup>16</sup> which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

With this proposal, CBOE seeks to eliminate the conflicts of interest that currently exist for their DPMs. Specifically, DPMs today trade for their own accounts as Market-Makers and act as agents for certain orders in their allocated options. CBOE has proposed to eliminate the DPM's obligation and permission to act as agent.<sup>17</sup> The Commission believes that eliminating a DPM's obligation and permission to act as agent will promote just and equitable principles of trade and protect investors and the public interest.<sup>18</sup>

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<sup>15</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>16</sup> 15 U.S.C. 78f(b)(5).

<sup>17</sup> The Commission notes that CBOE Rule 8.85(b), as amended, will no longer permit a DPM to act as an agent for customer orders. However, to the extent that a DPM nevertheless undertakes to represent a customer's order in violation of CBOE Rule 8.85(b), the DPM will assume all the duties and liabilities of an agent to a principal during the course of such representation. See Section 1 of the Restatement, 2d of Agency.

<sup>18</sup> In addition, CBOE Rule 4.18, Prevention of the Misuse of Material, Nonpublic Information, will have the effect of mitigating conflicts of interest that might arise when an affiliate of the DPM acts as agent for a customer order in one of the DPM's assigned options classes. CBOE Rule 4.18 requires that every member "shall establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by persons associated with such member." The Exchange represented that this requirement will have the effect of restricting the sharing of material, nonpublic information between the DPM and any affiliate of the DPM who acts as agent for a customer order. Telephone conversation between James Flynn, Assistant Secretary, CBOE, and Kelly Riley, Assistant Director, and Nathan Saunders, Special Counsel, Division, Commission, on October 21, 2005.

CBOE has proposed that orders that currently are represented by DPMs as agent be handled by Exchange employees known as PAR Officials and would require that their compensation be determined and paid exclusively by the Exchange. CBOE has also proposed to prohibit affiliations between PAR Officials and CBOE Market-Makers to ensure the PAR Officials are independent from Exchange Market-Makers' interests. The restrictions will mitigate potential conflicts of interest.

Pursuant to the proposed rule change, PAR Officials will undertake comparable responsibilities currently held by DPMs with respect to customer orders. For example, the PAR Official must use due diligence to execute the orders placed in his or her custody at the best prices available to him or her under the CBOE rules. In addition, PAR Officials will assume the obligations related to displaying public customer orders that improve CBOE's disseminated quote by maintaining Autobook, the Exchange's automated limit order display facility, and keeping it active. Accordingly, the Commission believes that the CBOE's proposal should ensure that customers' orders continue to be represented and handled in a timely fashion on the Exchange.

The PAR Officials would assume responsibilities related to Linkage Orders. Specifically, a PAR Official would use a DPM's account to route P/A Orders, Principal Orders on behalf of orders in the custody of the PAR Official that are for the account of a broker-dealer, and Satisfaction Orders to other participants in the Linkage Plan based on prior written instructions provided by the DPM to the PAR Official.<sup>19</sup> The written instructions provided by

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<sup>19</sup> The Commission today is also granting the CBOE a conditional exemption from the requirement in Rule 608(c) of Regulation NMS promulgated under the Act that the CBOE comply with and enforce compliance by its members with certain provisions of the Linkage Plan to facilitate the establishment of PAR Officials and their handling of Linkage Orders. See Letter from Robert L.D. Colby, Acting Director, Division of Market Regulation to Joanne Moffic-Silver, General Counsel, CBOE, dated November 18, 2005.

the DPM will also include direction as to how the PAR Official should handle responses to Linkage Orders routed to other Linkage Participants that are not responded to in a timely manner.<sup>20</sup> The PAR Official will also use the DPM's account to fill any Satisfaction Order that results from a Trade-Through that is effected on the Exchange by PAR Officials. Finally, the PAR Official will handle all Linkage Orders or portions of Linkage Orders received by the Exchange that are not automatically executed. The Commission believes that the proposed rules governing the handling of Linkage Orders by the PAR Official and the use of the DPMs' accounts for routing Linkage Orders is consistent with the promotion of a national market system because, among other things, it will allow P/A Orders that reflect the terms of CBOE customer orders to be generated by CBOE and routed to other Linkage Participant markets, which will allow a CBOE customer order to receive possible execution at a price better than the price disseminated by CBOE.

Pursuant to Section 19(b)(2) of the Act,<sup>21</sup> the Commission finds good cause for approving Amendments No. 2 and 4 prior to the thirtieth day after their publication in the Federal Register. In Amendment No. 2, CBOE has proposed an additional change to CBOE Rule 6.8(d)(vi). The additional change provides that DPMs no longer would be responsible for handling or representing RAES orders that are routed to the PAR workstation or to the Exchange's "Live Ammo" functionality when CBOE's disseminated quote is a manual quote (and thus is not eligible for automatic execution against the RAES order). This responsibility will belong to the PAR Official following implementation of the proposed rule change. In Amendment No. 4, CBOE has proposed additional conforming changes to CBOE Rules 6.45, 6.45A, 6.45B, 8.93,

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<sup>20</sup> CBOE Rule 6.81(d)(1) specifically addresses the situations in which a CBOE member does not receive a response to a P Order or P/A Order within 20 seconds of sending the order.

<sup>21</sup> 15 U.S.C. 78s(b)(2).

and 17.50 in order to render these rules consistent with the proposal as set forth in the Notice published in the Federal Register on July 19, 2005.

The Commission finds good cause to accelerate approval of the amended proposal because the changes proposed in Amendments No. 2 and 4 are consistent with the Exchange's broader proposal to remove a DPM's responsibility to act as agent for orders received on the PAR workstation and instead to assign this responsibility to the PAR Official.

V. Solicitation of Comments Concerning Amendments No. 2 and 4

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 2 and 4, including whether they are consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2005-46 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2005-46. 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 Exchange. 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-2005-46 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>22</sup> that the proposed rule change (File No. SR-CBOE-2005-46), as amended, is approved, and that Amendments No. 2 and 4 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>23</sup>

Jonathan G. Katz  
Secretary

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<sup>22</sup> 15 U.S.C. 78s(b)(2).

<sup>23</sup> 17 CFR 200.30-3(a)(12).