

*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*

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 proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR-BSE-2003-31. 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, comments should be sent in hardcopy or by e-mail but not by both methods. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the BSE. All submissions should refer to File No. SR-BSE-2003-31 and should be submitted by February 18, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-49108; File No. SR-CBOE-2004-01]**

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Incorporated Relating to the UMA Calculation for the CBOE Hybrid System**

January 21 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934,<sup>1</sup> notice

is hereby given that on January 8, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. On January 20, 2004, the Exchange submitted amendment No. 1 to the proposed rule change.<sup>2</sup> 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 CBOE proposes to allow the appropriate Index Floor Procedure Committee ("IFPC") to vary the component weightings of the Ultimate Matching Algorithm ("UMA") formula by product. The text of the proposed rule change appears below. Proposed new language is in *italics*; proposed deletions are in [brackets].

**Rule 6.45A Priority and Allocation of Trades for CBOE Hybrid System**

- (a)(i)
- (A) No change
- (B)(1) No change
- (B)(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**

$$\text{Incoming Order Size} * \frac{\begin{matrix} \text{(Equal Percentage based on} \\ \text{number of market participants} \\ \text{quoting at BBO)} \\ \text{(Component A)} \end{matrix} + \begin{matrix} \text{(Pro-rata Percentage based on size} \\ \text{of market participant quotes)} \\ \text{(Component B)} \end{matrix}}{2}$$

*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 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 for equity options, which shall be determined by the appropriate FPC and apply uniformly across all options under its jurisdiction, shall be a

<sup>6</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> See Letter from Stephen Youhn, Counsel, CBOE, to Deborah Flynn, Assistant Director, Division, Commission, dated January 20, 2004. In

Amendment No. 1, CBOE replaced in its entirety the original proposed rule filing.

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: ((Component A Percentage + Component B Percentage)/2)\* incoming order size.

[The final weighting shall apply uniformly across all options under the jurisdiction of the appropriate FPC.] *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 [in advance of implementation] via Regulatory Circular at least one day before implementation of the change.*

- (C) No change
- (b) No change
- (c)
- (i) No change

(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**

$$\text{Electronic Book Order(s) Size} * \frac{\begin{matrix} \text{(Equal percentage based on} \\ \text{number of members of "N-} \\ \text{second group")} \\ \text{(Component A)} \end{matrix} + \begin{matrix} \text{(Size pro-rata percentage based on} \\ \text{size of orders of "N-second group"} \\ \text{members)} \\ \text{(Component B)} \end{matrix}}{2}$$

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 participants 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 "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 FPC 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 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: ((Component A Percentage + Component B Percentage)/2)\* electronic book 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.*

- (A) No change

- (iii)–(iv) No change
- \* \* \* \* \*

**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. 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 parts of such statements.

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

1. Purpose

In May 2003, the Commission approved the CBOE's Hybrid System ("Hybrid System").<sup>3</sup> The Hybrid System merges the electronic and open outcry trading models, offering market participants the ability to stream electronically their own firm disseminated market quotes representing their trading interest. The Exchange currently trades equity options on Hybrid and recently commenced trading of index option and ETF option on Hybrid ("Index Hybrid filing").<sup>4</sup> As described in the Index Hybrid filing, the Exchange has the ability to trade on Hybrid index options

and options on ETFs pursuant to the existing Hybrid rules currently applicable to equity options.

CBOE Rule 6.45A governs the priority and allocation of trades on the CBOE Hybrid System. Paragraphs (a) and (c) of CBOE Rule 6.45A contain the UMA allocation model, which is a weighted formula that incorporates and blends the concepts of parity (Component A) and size prorata distribution (Component B). With respect to equity option trading, UMA assigns equal weighting percentages to Components A and B. Currently, all products under the jurisdiction of each floor procedure committee must utilize the same UMA weighting percentages (*i.e.*, Components A and B must be weighted the same in all products under that FPC's jurisdiction). The purpose of this rule filing is to amend Rule 6.45A(a) and (c) to allow the appropriate index FPC ("Index FPC" or "IFPC") to vary the final weighting percentages of Components A and B by index or ETF option product. For example, the IFPC may determine to weight Components A and B 50–50% for index XYZ while weighting the same components (60–40% for index ABC. The rule will remain unchanged on the equity side, thus, all equity options under the jurisdiction of the equity FPC must have the same UMA component weightings.

The Exchange believes it is appropriate to allow the IFPC to vary the weightings of Components A and B by product for several reasons. First, the size of trading crowds can vary dramatically by index/ETF option product. The ability to increase or decrease the percentage of Component A may serve as a better inducement to competitive quoting than would an

<sup>3</sup> Exchange Act Release 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) ("Hybrid Release").

<sup>4</sup> Exchange Act Release 48953 (December 18, 2003), 68 FR 75004 (December 29, 2003) (order approving SR-CBOE-2003-57).

equal-weighted formula.<sup>5</sup> Second, because the composition of trading crowds varies by product, it is highly likely that some index/ETF option crowds may consist of more larger capitalized market-making organizations than do other crowds, thus increasing the possibility that a “deep pocketed” market maker could “size out” his smaller counterparts, thereby reducing their incentive to quote competitively. Varying the weightings by product would allow the IFPC to take into account this factor and adjust the weightings accordingly so as to enhance competition. A third reason involves the trading characteristics of the index/ETF option product. In less liquid products, the IFPC may determine that increasing the weighting of Component B serves to enhance better quoting competition. Finally, index prices can be much higher and fluctuate far more on the index/ETF option side, which can significantly affect a trader’s risk profile. For example, the NDX index level (as of Mid December) was approximately 1400. Strike prices on the NDX ranged from \$500–1800 (in \$25 and/or \$50 increments).<sup>6</sup> The ability to vary the weightings of Components A and B will allow the IFPC to take into account the potential for tremendous swings in notional value due to the fluctuations in the indexes and the risk such swings can pose to traders.

The proposed rule requires that each time it changes the final weightings of UMA on a per product basis, it will provide at least one-day’s advance notice to the membership via Regulatory Circular. This precludes intra-days adjustments and serves to ensure sufficient advance notice to affected parties.<sup>7</sup>

## 2. Statutory Basis

The Exchange believes that allowing the IFPC to establish weightings for Components A and B of the UMA calculation at different levels for different index options and ETF option products will help to ensure optimal liquidity in each of these products under its jurisdiction. For this reason, the Exchange believes the proposed rule

<sup>5</sup> For example, less active indexes, such as the S&P Small Cap 600, may have trading crowds consisting of less than five market makers. More active indexes, such as the QQQ, may have as many as 20 market makers in the trading crowd. A “one-size-fits-all” weighting methodology for UMA may not produce optimal results in indexes with such disparate sized trading crowds.

<sup>6</sup> The premium for the 775 DEC call was bid at \$615.

<sup>7</sup> In this respect, the Exchange has not changed the UMA weighting percentages for Components A and B on the equity side since implementation of trading on Hybrid.

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.<sup>8</sup> Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)<sup>9</sup> 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.

### B. Self-Regulatory Organization’s Statement on Burden on Competition

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

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

The Exchange neither solicited nor received comments on the proposal.

## 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 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-CBOE-2004-01. 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, comments

should be sent in hardcopy or by e-mail but not by both methods. 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 will also be available for inspection and copying at the Commission’s Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of CBOE. All submissions should refer to the File No. SR-CBOE-2004-01 and should be submitted by February 18, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49111; File No. SR-CBOE-2003-51]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendments No. 1 and No. 2 Thereto by the Chicago Board Options Exchange, Inc. Relating to the Listing and Trading of Options on Certain Russell Indexes

January 21, 2004.

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> notice is hereby given that on October 30, 2003, the Chicago Board Options Exchange, Inc. (“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 November 25, 2003, the Exchange filed an amendment to the proposed rule

<sup>10</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>8</sup> 15 U.S.C. 78(f)(b).

<sup>9</sup> 15 U.S.C. 78(f)(b)(5).