

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 Room. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to File No. SR-Amex 2003-39 and should be submitted by March 24, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49318; File No. SR-CBOE-2004-10]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to the Expansion of the \$5 Bid-Ask Differential Pilot Program

February 25, 2004.

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 February 20, 2004, 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 and II below, which items have been prepared by the Exchange. The CBOE has submitted the proposed rule change under section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission. 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

In January 2004, the CBOE implemented a six-month pilot program ("Pilot Program"), which expires on June 29, 2004, that permits quote spread parameters of up to \$5, regardless of the price of the bid, for up to 200 option classes traded on the CBOE's Hybrid Trading System ("Hybrid").⁵ The CBOE proposes to amend its rules to expand the Pilot Program to include all option classes traded on Hybrid.

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 aspects of such statements.

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

1. Purpose

The Pilot Program, which expires on June 29, 2004, permits quote spread parameters of up to \$5, regardless of the price of the bid, for up to 200 option classes traded on Hybrid. The purpose of the proposed rule change is to expand the Pilot Program to include all option classes traded on Hybrid.⁶ As a condition to the effectiveness of the Pilot Program, the CBOE committed to monitor the quotation quality of all classes in the Pilot Program and, based on the results, recommend either relaxing the spread requirements for all Hybrid classes, ending the Pilot Program, or adjusting the spread requirements for all Hybrid classes. To this end, the CBOE committed to prepare and submit to the Commission a report assessing the operation of the Pilot Program and, in particular, the

quality of the quotations for the Pilot Program options.⁷

The CBOE proposes to expand the number of option classes included in the Pilot Program from 200 classes to all classes trading on Hybrid. As proposed, any class trading on Hybrid would be eligible for inclusion in the Pilot Program, which means that when the proposal becomes operative, the permissible bid-ask differential for all Hybrid series will be \$5, regardless of the price at which they trade.⁸

As described above, the CBOE previously committed to prepare and submit to the Commission a report assessing the operation of the Pilot Program. The CBOE further commits to expand the scope of this report to include the top 550 Hybrid classes. The report will analyze the AQWA scores for the Pilot Program options and will include data from the date of inclusion in the Pilot Program through June 1, 2004.⁹

The CBOE believes that it is reasonable to expand the Pilot Program to include all Hybrid classes. In this

⁷ In this respect, the CBOE committed to provide to the Commission a report analyzing the Average Quote Width Analysis ("AQWA") scores for each of the Pilot Program options. The CBOE's report will compare the AQWA scores for each stock prior to the implementation of the Pilot Program versus the AQWA scores for each stock during the operation of the Pilot Program. The CBOE believes that this information will provide a meaningful comparison during the relevant periods so that the CBOE will be able to determine the effect of the \$5 quote width on quote quality. The CBOE expects to provide the Commission with its report on the Pilot Program by June 15, 2004. Telephone conversation between Steve Youhn, CBOE, and Yvonne Fraticelli, Special Counsel, Division of Market Regulation, Commission, on February 19, 2004.

⁸ The relaxed quotation spread requirements will apply after the opening trading rotation. During the opening rotation, market makers will be required to quote in accordance with the traditional bid-ask width requirements. The \$5 quotation requirements permitted under the Pilot Program would become operative immediately following the opening rotation.

⁹ See note 7, *supra*, for a description of the information that the CBOE will include in its Pilot Program report. When the current proposal becomes operative, the CBOE will add to the 200 classes currently included in the Pilot Program all of the remaining classes currently traded on Hybrid (approximately 350 classes). If after the operative date of the current proposal the CBOE converts additional classes to Hybrid trading, those classes will be eligible for inclusion in the Pilot Program. However, the CBOE will not include data for these additional classes in its Pilot Program report to the Commission. The CBOE proposes to exclude this information from the report because these classes may be added to Hybrid at different times (and some may not be added until near the end of the Pilot Program), which would result in separate measurement periods for each class and would necessarily complicate the preparation of the Pilot Program report. Moreover, the CBOE believes that it is unlikely that data provided for this relatively small number of classes would produce significant additional information concerning the operation of the Pilot Program.

¹⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ See Securities Exchange Act Release No. 49153 (January 29, 2004), 69 FR 5620 (February 5, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2003-50) ("Pilot Notice").

⁶ As of February 17, 2004, approximately 550 classes traded on Hybrid.

regard, the CBOE notes that the Hybrid market structure creates strong incentives for competing market makers and other market participants to disseminate competitive prices. In Hybrid, each market maker quotes independently and customers and broker-dealers can enter limit orders in the limit order book at prices better than those posted by market makers. The Exchange automatically collects this trading interest information, calculates the CBOE best bid and offer, and disseminates that value to the Options Price Reporting Authority. Accordingly, the CBOE believes that the CBOE Hybrid market is competitive, accessible and transparent.

The CBOE notes that market participants in Hybrid have strong incentives to quote competitively. The CBOE allocates incoming orders based on the price and size of orders and quotes resting in the book. Under the CBOE's Ultimate Matching Algorithm, the larger the size of a market maker's quote at the best price, the greater the size of the allocation he or she receives. Conversely, if a market participant does not quote at the best price, the market participant will not participate in any electronic trade allocations. The CBOE believes, moreover, that given NBBO protections in place at each exchange as well as through the Options Market Linkage plan, market participants have even stronger incentives to quote at the best price, lest incoming orders be filled away. Thus, the CBOE believes that inter- and intra-market competitive forces provide strong incentives for market participants to quote competitively and enter quotes and orders that improve the price and depth of the market.

For these reasons, the CBOE believes that it is reasonable to expand the Pilot Program to include all Hybrid classes.

2. Statutory Basis

The 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.¹⁰ Specifically, the CBOE believes the proposed rule change is consistent with the section 6(b)(5)¹¹ 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.

¹⁰ 15 U.S.C. 78f.

¹¹ 15 U.S.C. 78f(b)(5).

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

The 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 Act.

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

No written comments were solicited or received.

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

The CBOE has filed the proposed rule change pursuant to section 19(b)(3)(A) of the Act¹² and subparagraph (f)(6) of Rule 19b-4 thereunder.¹³ Because the foregoing proposed rule change: (1) Does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for 30 days, or such shorter time as the Commission may designate, and the CBOE provided the Commission with written notice of its intent to file the proposed rule change at least five business days prior to the filing date, the proposed rule change has become effective pursuant to section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder.

A proposed rule change filed under Rule 19b-4(f)(6) normally does not become operative prior to 30 days after the date of filing. However, Rule 19b-4(f)(6)(iii) permits the Commission to designate a shorter time if such action is consistent with the protection of investors and the public interest. The CBOE has requested that the Commission waive the 30-day operative delay to allow the CBOE to expand the Pilot Program to include all Hybrid classes without delay. The CBOE notes that its Pilot Program is similar to a pilot program adopted by the International Securities Exchange, Inc. ("ISE").¹⁴

¹² 15 U.S.C. 78s(b)(3)(A).

¹³ 17 CFR 240.19b-4(f)(6).

¹⁴ See Securities Exchange Act Release No. 47352 (March 19, 2003), 68 FR 14728 (March 26, 2003) (order approving File No. SR-ISE-2001-15). The ISE's pilot program has been extended through March 31, 2004. See Securities Exchange Act Release No. 49149 (January 29, 2004), 69 FR 5627 (February 5, 2004) (notice of filing and immediate effectiveness of File No. SR-ISE-2004-02, extending the ISE's pilot program through March 31, 2004). See also Securities Exchange Act Release No. 48514 (September 22, 2003), 68 FR 55685 (September 26, 2003) (notice of filing and immediate effectiveness of File No. SR-ISE-2003-21, extending the ISE's pilot program through

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest.¹⁵ Specifically, the Commission believes that allowing the CBOE to expand its Pilot Program to include all option classes trading on Hybrid will permit a larger number of option classes to be included in the Pilot Program, thereby helping the CBOE to assess the effects of the \$5 spreads permitted under the Pilot Program. In this regard, the Commission notes that the CBOE's report concerning the Pilot Program will include data from 550 option classes traded on Hybrid. The Commission believes that the CBOE's proposal raises no new issues or regulatory concerns that the Commission did not consider in approving the ISE's quote spread pilot program or in permitting the CBOE to implement its Pilot Program.¹⁶ For these reasons, the Commission designates that the proposal become operative immediately.

At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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. 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-CBOE-2004-10. 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, your comments should be sent in hardcopy or by e-mail but not by both methods.

Copies of the submission, all subsequent amendments, all written

January 31, 2004). The ISE also has filed a proposal with the Commission seeking permanent approval of its pilot program and extending its pilot program to apply to all equity options listed on the ISE. See File No. SR-ISE-2003-22.

¹⁵ For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ See Pilot Notice, *supra* note 5.

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 principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2004-10 and should be submitted by March 24, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49323; File No. SR-ISE-2003-06]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the International Securities Exchange, Inc. to Establish Rules Implementing a Price Improvement Mechanism

February 26, 2004.

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 February 25, 2003, the International Securities Exchange, Inc. ("ISE" 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 Exchange. On February 25, 2004, the ISE submitted Amendment No. 1 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated February 24, 2004 ("Amendment No. 1"). In Amendment No. 1, the ISE replaced the proposed rule text in its entirety.

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

The Exchange is proposing to adopt rules implementing a "Price Improvement Mechanism" ("PIM"). Proposed new language is *italicized*; proposed deletions are in [brackets].

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Rule 717. Limitations on Orders.

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(d) Principal Transactions.

Electronic Access Members may not execute as principal orders they represent as agent unless (i) agency orders are first exposed on the Exchange for at least thirty (30) seconds, (ii) the Electronic Access Member has been bidding or offering on the Exchange for at least thirty (30) seconds prior to receiving an agency order that is executable against such bid or offer, [or] (iii) the Member utilizes the Facilitation Mechanism pursuant to Rule 716(d), or (iv) the Member utilizes the Price Improvement Mechanism for Crossing Transactions pursuant to Rule 723.

(e) Solicitation Orders.

Electronic Access Members must expose orders they represent as agent on the Exchange for at least thirty (30) seconds before such orders may be executed in whole or in part by orders solicited from Members and non-member broker-dealers to transact with such orders, *unless with respect to orders solicited from Members, the Member utilizes the Price Improvement Mechanism for Crossing Transactions pursuant to Rule 723.*

* * * * *

Rule 723. Price Improvement Mechanism for Crossing Transactions

(a) *The Price Improvement Mechanism is a process by which an Electronic Access Member can provide price improvement opportunities for a transaction wherein the Electronic Access Member seeks to facilitate an order it represents as agent, or a transaction wherein the Electronic Access Member solicited an order from a Member to execute against an order it represents as agent (a "Crossing Transaction").*

(b) *Crossing Transaction Entry. A Crossing Transaction is comprised of the order the Electronic Access Member represents as agent (the "Agency Order") and a counter-side order for the full size of the Agency Order (the "Counter-Side Order").*

(1) *A Crossing Transaction must be entered only at a price that is better than the national best bid or offer ("NBBO"), and only when there are at*

least three (3) market makers quoting in the options series.

(2) *The Crossing Transaction may be priced in one-cent increments.*

(3) *The Crossing Transaction may not be canceled, but the price of the Counter-Side Order may be improved during the exposure period.*

(c) *Exposure Period. Upon entry of a Crossing Transaction into the Price Improvement Mechanism, a broadcast message will be sent to all Members. This broadcast message will not be included in the ISE disseminated best bid or offer and will not be disseminated through OPRA.*

(1) *Members will be given three seconds to indicate the size and price at which they want to participate in the execution of the Agency Order ("Improvement Orders").*

(2) *Improvement Orders may be entered by all Members for their own account or for the account of a Public Customer in one-cent increments at the same price as the Crossing Transaction or at an improved price for the Agency Order, and for any size up to the size of the Agency Order.*

(3) *During the exposure period, Improvement Orders may not be canceled, but may be modified to (1) increase the size at the same price, or (2) improve the price of the Improvement Order for any size up to the size of the Agency Order.*

(4) *During the exposure period, the aggregate size of the best-priced Improvement Orders will continually be updated and broadcast to all Members.*

(5) *The exposure period will automatically terminate (i) at the end of the three second period, (ii) upon the receipt of a market or marketable limit order on the Exchange in the same series, or (iii) upon the receipt of a non-marketable limit order in the same series on the same side of the market as the Agency Order that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange.*

(d) *Execution. At the end of the exposure period the Agency Order will be executed in full at the best prices available, taking into consideration orders and quotes in the Exchange market, Improvement Orders and the Counter-Side Order. The Agency Order will receive executions at multiple price levels if there is insufficient size to execute the entire order at the best price.*

(1) *At a given price, Public Customer interest is executed in full before any Non-Customer interest.*

(2) *After Public Customer interest at a given price, agency orders for the account of non-Member broker-dealers*