SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50003; File No. SR–CBOE–2004–24]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change Allowing a New Type of Designated Primary Market-Maker—e-DPMs

July 12, 2004.

I. Introduction

On April 22, 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 amend its rules to allow remote competing Designated Primary Market-Makers (''DPMs''). On April 30, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.[3] On May 7, 2004, the CBOE's rule proposal, as amended, was published for comment in the **Federal Register**.[4] No comment letters were received on the proposal. On June 15, 2004, the CBOE filed Amendment No. 2 to the proposed rule change.[5] The Commission is approving the proposed rule change and Amendment No. 1 thereto, and is publishing notice of and granting accelerated approval to Amendment No. 2 to the proposed rule change.

II. Description of Proposal

The CBOE's Hybrid Trading System is an electronic trading platform integrated with its floor-based open-outcry auction market.[6] The CBOE proposes to enhance the Hybrid platform by adding a new category of CBOE market-making participant—electronic DPMs (''e-DPMs''). e-DPMs would be member organizations appointed to operate on the CBOE as competing DPMs/specialists in a broad number of option classes, and would therefore be permitted to share in the DPM participation right in their allocated option classes. e-DPMs would enter bids and offers electronically from locations other than the trading crowds where the applicable option classes are traded, and would not be required to have traders physically present in the trading crowd.

A. Appointment, Allocation, and Membership Requirements for e-DPMs

Under the proposal, e-DPMs may apply for and be granted an appointment in any option classes on the Hybrid Trading System other than those in which they are already operating as the DPM on the floor of the Exchange.[7] The CBOE also proposes to require e-DPMs to accept allocations in a broad number of option classes. All classes allocated by the Exchange to an e-DPM would constitute the e-DPM's appointment.

e-DPMs would be required to own or lease CBOE or Chicago Board of Trade (exercised) memberships to operate as e-DPMs on the Exchange. Each membership that an e-DPM owns would entitle the e-DPM to stream quotes into 30 allocated classes. Each membership that an e-DPM leases would entitle the e-DPM to stream quotes into 20 allocated classes. At the end of three years, the CBOE would require every e-DPM to own seats to satisfy this requirement and thereafter the e-DPM would no longer be allowed to use leased seats for this purpose.

B. e-DPM Obligations

e-DPMs would have specific obligations governing all classes comprising their appointments. Specifically, proposed CBOE Rule 8.93(i) would require each e-DPM to provide continuous, two-sided quotations in at least 90% of the series of each allocated class with a minimum size of at least 10 contracts.[8] In addition, the proposal would require all e-DPM quotations to be firm and to comply with the maximum bid-ask width requirements contained in CBOE Rule 8.7(b)(iv). Each e-DPM also would be required to make competitive markets on the Exchange and otherwise to promote the Exchange in a manner that is likely to enhance the ability of the Exchange to compete successfully for order flow in the classes it trades. Each e-DPM would be required to notify the Exchange immediately of any material operational or financial changes to the e-DPM organization and to obtain the Exchange's approval prior to effecting changes to the ownership, capital structure, voting authority, distribution of profits/losses, or control of the e-DPM organization. Moreover, each e-DPM would be obligated to maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the e-DPM or act as specialist or market maker in any security underlying options allocated to the e-DPM. Other proposed e-DPM obligations are set forth in proposed CBOE Rule 8.93.

C. Affiliated Floor-Market Maker Pilot Program

The CBOE also proposes, as a pilot program for an 18-month period commencing on Commission approval of this proposal, to allow an e-DPM to choose to have a separate affiliated Market-Maker physically present in trading crowds where it operates as an e-DPM, provided that such Market-Maker trades on a separate

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[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Amendment No. 1 replaced and superceded the CBOE's original 19b–4 filing in its entirety.

[4] *See* Securities Exchange Act Release No. 49643 (April 30, 2004), 69 FR 25647.

[5] *See* letter from Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, to Deborah L. Flynn, Assistant Director, and Sapna Patel, Special Counsel, Division of Market Regulation (''Division''), Commission, dated June 14, 2004 (''Amendment No. 2''). In Amendment No. 2, the CBOE proposes technical changes to the proposed rule text to indicate proposed new rule language and to clarify e-DPM obligations and performance review standards. In connection with the CBOE's proposal to reduce the ''counting period'' to one second, the CBOE proposes to modify CBOE Rule 6.45A(d) to delete the requirement that when Market-Maker quotes interact with other Market-Maker quotes and result in quote locks that last one second or less, the Market-Markers locking the market are obligated to trade one contract in open outcry. The CBOE has, in conjunction with its proposed changes to CBOE Rule 6.45A(d), requested an exemption from Rule 11Ac1–1 under the Act (''Quote Rule'') for Market-Maker quote locks that do not exceed one second. *See* letter from Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE, to Annette Nazareth, Director, Division, Commission, dated July 9, 2004 (''CBOE Exemption Request Letter''). Under separate cover, the Commission has granted Market-Makers an exemption pursuant to paragraph (e) of the Quote Rule from their obligations under paragraph (c)(2) of the Quote Rule with respect to interlocking Market-Maker quotations in Hybrid classes that last for no more than one second, provided that such Market-Makers' quotes are firm for all customer and broker-dealer orders, including orders for the accounts of other options market makers. See letter from David Shillman, Associate Director, Division, Commission, to Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, dated July 12, 2004 (''SEC Exemption Letter'').

[6] *See* Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003).

[7] The process and rules by which e-DPMs would be appointed was submitted to the Commission as a separate proposed rule change (File No. SR–CBOE–2004–17). The Commission approved the CBOE's appointment criteria for e-DPMs on April 19, 2004. *See* Securities Exchange Act Release 49577, 69 FR 22576 (April 26, 2004) (''e-DPM Appointment Criteria Approval Order'').

[8] If an electronic request-for-quote (''RFQ'') functionality is activated for Hybrid classes, e-DPMs would have additional or alternative obligations regarding RFQs, including the obligation to respond to at least 98% of RFQs in their appointed classes. The RFQ functionality currently exists for trading on CBOE*direct*, the Exchange's purely screen-based trading platform.

membership.[9] The CBOE represents that this affiliated Market-Maker would be allowed all the privileges of any other Market-Maker and would have all of the responsibilities of any other Market-Maker.

D. Participation Entitlement

The CBOE proposes to modify certain aspects of the DPM participation entitlement—rights granted to a DPM when the DPM is quoting on the prevailing bid or offer—to accommodate the e-DPM program. The CBOE's current DPM participation rights are 30%, 40%, or 50%.[10] Under this proposal, the CBOE proposes that DPMs and e-DPMs (the ''DPM Complex'') would share in the existing DPM participation entitlement with the e-DPM participation right coming out of the existing DPM participation right established under CBOE Rule 8.87.

The CBOE proposes that the DPM participation entitlement to the DPM Complex would be allocated in the following manner: If the DPM and one or more e-DPMs were quoting at the best bid/offer on the CBOE, the e-DPM participation entitlement would be one-half (50%) of the total DPM Complex entitlement and would be divided equally by the number of e-DPMs quoting at the best bid/offer on the CBOE, while the DPM would retain the other half of the entitlement. If the DPM were not quoting at the best bid/offer on the Exchange and one or more e-DPMs were quoting at the best bid/offer on the Exchange, then the e-DPM(s) would be allocated the entire participation entitlement, which would be divided up equally between them. If, however, only the DPM and/or e-DPM(s) were quoting at the best bid/offer on the CBOE and there were no Market-Makers quoting with them, there would be no DPM/e-DPM participation entitlement and instead the allocation procedures under CBOE Rule 6.45A would apply. Pursuant to proposed CBOE Rule 6.45A, e-DPMs would receive allocations based on the greater of the participation entitlement or what the e-DPM would otherwise receive via the CBOE's Ultimate Matching Algorithm (''UMA''), and an e-DPM would never receive an allocation greater than the size of its quote.

E. Proposed Extra ''A'' Component in UMA for DPMs

In addition, the CBOE proposes to allow a DPM that uses more than one membership in any given trading crowd to increase its ability to participate via UMA by increasing the DPM's ''A'' component in the UMA calculation by one.[11] The CBOE represents that on many exchanges the specialist receives a 40% guarantee when there are at least three other market makers quoting the best price. On the CBOE, the DPM is entitled to only 30% in such cases. To the extent this extra ''A'' component could be considered a ''guarantee'' (and even though a DPM would not receive an allocation on any trade pursuant to both the participation entitlement and UMA), the CBOE represents that it would not allow the incremental amount a DPM receives because of the proposed second ''A'' component to cause the DPM to exceed a 40% ''guarantee'' threshold.

F. Performance and Operations Review for e-DPMs

Reviews of e-DPM performance would be conducted under proposed new CBOE Rule 8.94(a). Furthermore, proposed CBOE Rule 8.94(b) would provide that the Exchange may, pursuant to a proposed rule change filed with the Commission under Section 19(b) of the Act, adopt rules detailing objective criteria upon which e-DPMs' fee rates shall be reviewed. Such objective criteria, if approved by the Commission, may include average quote size, average quote width, the percentage of time an e-DPM is quoting at the National Best Bid or Offer, and other objective performance related measurements. The proposed rule further states that e-DPMs that fail to meet the objective standards could be summarily required to adhere to fee rates applicable to certain non-e-DPM Market-Makers. Proposed CBOE Rule 8.94(c) provides that the Exchange may terminate, place conditions upon, or otherwise limit a member organization's approval to act as an e-DPM on the same basis that DPM privileges may be terminated and/or conditioned under CBOE Rules 8.60 and 8.90, and that if a member organization's approval to act as an e-DPM were terminated, conditioned, or otherwise limited by the Exchange pursuant to this Rule, the member organization would be permitted to seek review of that decision under Chapter XIX of the CBOE Rules.

G. Limitations on Access Due to Systems Constraints

The CBOE is also proposing new CBOE Rule 6.23A, which provides that the Exchange may limit the number of messages sent by members accessing the Exchange electronically to ensure proper performance of the system, to protect the integrity of the Hybrid Trading System. However, proposed CBOE Rule 6.23A explicitly states that any such restrictions must be objectively determined and submitted to the Commission for approval pursuant to a proposed rule change under Section 19 of the Act.[12]

III. Description of Amendment No. 2 to the Proposed Rule Change

In Amendment No. 2 to the proposed rule change, the CBOE proposes changes to CBOE Rule 6.45A(d) to delete the requirement that when Market-Maker quotes interact with other Market-Maker quotes and result in quote locks that last one second or less, the Market-Markers locking the market are obligated to trade one contract in open outcry.[13] In addition, the CBOE proposes to limit the ''counting period'' established by the rule to one second, during which time such Market-Makers would be obligated to execute customer and broker-dealer orders eligible for automatic execution. Quote locks that last more than one second would execute against each other for the full size.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning whether the Amendment No. 2 to the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or

[9] As part of the pilot program, the CBOE states that it would confidentially provide the Commission with data on: (1) The size of orders that e-DPMs and affiliated Market-Makers both trade with electronically; (2) the price and size of the e-DPM's and the affiliated Market-Maker's respective quotes; (3) the price and size of quotes of other participants in classes where an e-DPM and an affiliate are quoting; and (4) a breakdown of how orders are allocated to the e-DPM, the affiliated Market-Maker, and any other participants.

[10] If there is one Market-Maker quoting with the DPM, the DPM entitlement is 50%. If there are two Market-Makers quoting with the DPM, the DPM entitlement is 40%. If there are three or more Market-Makers quoting with the DPM, the DPM entitlement is 30%. *See* CBOE Regulatory Circular RG00–193.

[11] The ''A'' component of UMA represents 1 over the total number of market participants on the market. UMA currently gives equal weighting to the ''A'' and ''B'' components. When the DPM is given credit for the additional memberships, both the numerator and the denominator would be increased by no more than 1 (*e.g.*, ¼ would become ⅖).

[12] 15 U.S.C. 78s.

[13] The CBOE has, in conjunction with its proposed changes to Rule 6.45A(d), requested an exemption from the Quote Rule for Market-Maker quote locks that do not exceed one second. *See* CBOE Exemption Request Letter, *supra* note 5.

• Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–CBOE–2004–24 on the subject line.

Paper Comments

• Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–CBOE–2004–24. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of 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–2004–24 and should be submitted on or before August 9, 2004.

V. 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 a national securities exchange [14] and, in particular, the requirements of Section 6 of the Act.[15] Specifically, the Commission finds that the proposal to add a new category of CBOE market making participant, e-DPMs, to the CBOE's Hybrid platform is consistent with Section 6(b)(5) of the Act,[16] in that the proposal has been designed to promote just and equitable principles of trade, and to protect investors and the public interest.

The Commission notes that e-DPMs would essentially operate as remote, electronic competing specialists on the CBOE. As such, e-DPMs would have additional responsibilities and obligations compared to other CBOE Market-Makers, including an obligation to participate as an e-DPM in a broad number of option classes and an enhanced continuous quoting requirement for the quotes that they stream to the Exchange from locations outside of the trading crowd. In return for undertaking these additional responsibilities, e-DPMs would receive the benefit of sharing in the DPM's participation entitlement in their appointed option classes. The Commission further notes that the CBOE has proposed special rules and requirements to accommodate the introduction of e-DPMs on the Exchange, including rules on the allocation of option classes based on memberships, heightened obligations in connection with their allocated option classes, and specific operations and performance review criteria. The Commission believes that these proposed new rules for e-DPMs should place affirmative obligations on e-DPMs. The Commission therefore finds that, for the reasons discussed more fully below, the CBOE's proposal to allow e-DPMs to operate as competing specialists on its Hybrid system is consistent with the Act.

A. Appointment, Allocation, and Membership Requirements for e-DPMs

The Commission notes that e-DPMs may not quote in option classes other than their appointed/allocated classes. Moreover, although there could be more than one e-DPM in a particular option class (from separate member organizations), the Commission notes that an e-DPM may not be allocated an option class in which its member organization serves as a DPM. The Commission believes that these limitations should help to reduce the opportunity for conflicts of interest detrimental to the interests of investors.

B. e-DPM Obligations

The Commission further notes that proposed CBOE Rule 8.93 provides a list of obligations that an e-DPM would be required to fulfill in addition to (or, in certain cases, in lieu of) those of a CBOE Market-Maker or DPM. One particular obligation would require e-DPMs to provide two-sided quotations in at least 90% of the series of each of its allocated option classes, or if the RFQ functionality is utilized by the Exchange, to respond to 98% of the RFQs. Another proposed obligation would require e-DPMs to ''make competitive markets on the Exchange and otherwise to promote the Exchange in a manner that is likely to enhance the ability of the Exchange to compete successfully for order flow in the classes it trades.'' The Commission emphasizes that the CBOE should not interpret this proposed obligation to in any way directly or indirectly attempt to restrict a market participant that is appointed as an e-DPM on the CBOE from performing market-making or specialist activities on other markets.

The Commission notes that e-DPMs, in addition to complying with the requirements of CBOE Rule 4.18, also would be obligated to maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the e-DPM or act as specialist or market maker in any security underlying options allocated to the e-DPM. The Commission believes that the requirement that there be an information barrier between an e-DPM and its affiliates with respect to transactions in its allocated option classes and the related underlying securities should serve to reduce the opportunity for unfair trading advantages or misuse of material, non-public information.

C. Affiliated Floor Market-Maker Pilot Program

The Commission is permitting the CBOE, for an 18-month pilot period commencing on Commission approval of this proposal, to allow an e-DPM to choose to have an affiliated Market-Maker, trading on a separate membership, physically present in trading crowds where it operates as an e-DPM. The CBOE has committed to, during this pilot period, provide to the Commission data relating to: (1) The size of orders that e-DPMs and affiliated Market-Makers both trade with electronically; (2) the price and size of the e-DPM's and the affiliated Market-Maker's respective quotes; (3) the price and size of quotes of other participants in classes where an e-DPM and an affiliate are quoting; and (4) a breakdown of how orders are allocated to the e-DPM, the affiliated Market-Maker, and any other participants. The Commission expects to use this data to determine if the practice of allowing a member organization to receive more of an allocation of orders based simply on the number of Market-Makers that it has

[14] The Commission has considered the amended proposed rule change's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

[15] 15 U.S.C. 78f.

[16] 15 U.S.C. 78f(b)(5).

quoting in an option class is unfairly discriminatory in any way to other quoting market participants, and to determine whether to extend or permanently approve this practice.

D. Participation Entitlement

The Commission notes that the CBOE proposes to allow e-DPMs to share in the DPM's participation entitlement. If the DPM and one or more e-DPMs were quoting at the best bid/offer on the CBOE in a particular option class, the e-DPM(s) would be entitled to share 50% of the DPM's participation entitlement, which would then be divided equally by the number of e-DPMs quoting at the best bid/offer on the CBOE.[17] e-DPMs would receive allocations based only on the greater of the participation entitlement or what the e-DPM would otherwise receive through UMA, but in no event greater than the size of its quote. The Commission notes, however, that if only the DPM and/or e-DPM(s) were quoting at the best bid/offer on the CBOE with no other Market-Makers quoting with them, there would be no participation entitlement and instead the allocation procedures under CBOE Rule 6.45A would apply. The Commission believes that because e-DPMs have certain obligations greater than those of other Market-Makers on the CBOE, it would not be inappropriate for e-DPMs that are quoting at the CBOE's best bid/offer with the DPM to be permitted to receive a portion of the DPM's participation entitlement.

E. Proposed Extra ''A'' Component in UMA for DPMs

Furthermore, the Commission notes that the CBOE proposes to allow DPMs that use more than one membership in any given trading crowd to increase their ability to participate via UMA by increasing the DPM's ''A'' component in the UMA calculation by one. The CBOE represents that this extra ''A'' component would not have an impact on the DPM's participation guarantee, and that it would not allow the incremental amount a DPM receives because of a second ''A'' component to cause the DPM to exceed a 40% ''guarantee'' threshold. While the CBOE represents that the reason DPMs should receive an extra ''A'' component is because they would receive less of a participation guarantee with the introduction of e-DPMs on the Exchange and would continue to need multiple memberships to effectively operate as a DPM in the trading crowd, the Commission notes that the number of memberships needed to operate as a DPM is not a factor that it is considering in determining whether allowing DPMs an extra ''A'' component is consistent with the Act.

F. Performance and Operations Reviews for e-DPMs

The Commission notes that the CBOE has proposed performance review standards pursuant to proposed CBOE Rule 8.94(a), which would take into account how well an e-DPM has fulfilled its obligations under proposed CBOE Rule 8.93. Furthermore, the Commission notes that proposed CBOE Rule 8.94(b) provides that the CBOE may adopt rules in the future, subject to Commission approval, with detailed objective criteria upon which e-DPMs' fee rates could be reviewed. Moreover, the Commission believes that proposed CBOE Rule 8.94(c) should provide guidance regarding the termination or limitation of a member organization's approval to act as an e-DPM, and the ability of the member organization to appeal such decision.

G. Limitations on Access Due to Systems Constraints

In addition, the Commission notes that proposed new CBOE Rule 6.23A, which would allow the Exchange to limit the number of messages sent by members accessing the Exchange to protect the Hybrid Trading System, grants the Exchange no authority at this time and therefore, would not permit the CBOE to place any limitations on its members under this rule unless such limitations were objectively determined and submitted as a proposed rule change to the Commission for approval pursuant to Section 19(b) of the Act.[18]

H. Quote Locks

In Amendment No. 2, the CBOE proposes changes to CBOE Rule 6.45A(d) to delete the requirement that when Market-Maker quotes interact with other Market-Maker quotes and result in quote locks that last one second or less, the Market-Markers locking the market are obligated to trade one contract in open outcry. In addition, the CBOE proposes limiting the ''counting period'' to one second during which time Market-Makers whose quotes are locked may eliminate the locked market. Quote locks that last more than one second would result in the quotes executing against each other for the full size. The CBOE represents that quote locks that occur between Market-Makers are mainly due to technological disparities. The CBOE has therefore, in conjunction with its proposed changes to CBOE Rule 6.45A(d), requested an exemption from the Quote Rule for Market-Maker quote locks that do not exceed one second.[19] The Commission has granted the CBOE an exemption from the Quote Rule solely under this limited circumstance, provided that Market-Makers' quotes are firm for all customer and broker-dealer orders, including orders for the accounts of other options market makers.[20] The Commission believes a requirement that an e-DPM trade one contract in open outcry if it locks the quote of another Market-Maker would be impractical in an environment in which market-making participants can stream quotes electronically from locations outside of the trading crowd in their allocated option classes without physically being present on the trading floor, especially if such a quote lock occurs due to technological differences.

VI. Accelerated Approval of Amendment No. 2 to the Proposed Rule Change

Finally, the Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the **Federal Register** pursuant to Section 19(b)(2) of the Act.[21] In Amendment No. 2, the CBOE proposes technical changes to the proposed rule text to indicate proposed new rule language and to clarify e-DPM obligations and performance review standards. Furthermore, the CBOE proposes amendments to CBOE Rule 6.45A(d) to reduce the ''counting period'' to one second and to delete the requirement that when Market-Maker quotes interact with other Market-Maker quotes and result in quote locks that last one second or less, the Market-Markers locking the market are obligated to trade one contract in open outcry. The Commission believes that the proposed changes in Amendment No. 2 are necessary to the efficient and orderly introduction of remote e-DPMs and to the proper operation of the CBOE's Hybrid Trading System and, therefore, believes that accelerated approval of Amendment No. 2 is appropriate.

[17] The Commission notes that proposed CBOE Rule 8.87(b)(1)(iii) provides that 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.

[18] 15 U.S.C. 78s(b).

[19] *See* CBOE Exemption Request Letter, *supra* note 5.

[20] *See* SEC Exemption Letter, *supra* note 5.

[21] 15 U.S.C. 78s(b)(2).

VII. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[22] that the proposed rule change (File No. SR–CBOE–2004–24) and Amendment No. 1 are hereby approved, and that Amendment No. 2 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[23]

Jill M. Peterson,

Assistant Secretary.

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[22] 15 U.S.C. 78s(b)(2).

[23] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50005; File No. SR–CBOE–2004–33]

Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Change by the Chicago Board Options Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to Frequency of Executions on the Hybrid Trading System

July 12, 2004.

I. Introduction

On May 19, 2004, the Chicago Board Options Exchange, Inc. (''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 governing the frequency with which orders for the account of market makers or specialists on an options exchange (''options market maker''), or for the account of a stock exchange specialist with respect to a security in which it acts as specialist, may be submitted for automatic execution in the Exchange's Hybrid Trading System (''Hybrid''). The proposed rule change was published in the **Federal Register** on June 14, 2004.[3] On July 12, 2004, the Exchange submitted by facsimile Amendment No. 1 to the proposal.[4]

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 49814 (June 4, 2004), 69 FR 33090.

[4] *See* letter from Steve Youhn, Senior Attorney, Legal Division, CBOE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated July 12, 2004 (''Amendment No. 1'').

The Commission received no comments on the proposed rule change. This order approves the proposed rule change on an accelerated basis. Simultaneously, the Commission provides notice of filing and grants accelerated approval of Amendment No. 1.

II. Description of Proposal and Amendment No. 1

Currently, CBOE Rule 6.8(e)(iii) restricts the entry of certain orders into the Exchange's RAES system to one order within any 15-second period on the same side of the market in an option class, when such order is for an account or accounts of the same beneficial owner. The proposed rule change seeks to adopt a similar 15-second rule applicable to options market maker and stock exchange specialist orders entered into Hybrid, which would be implemented for a six-month pilot period.

Specifically, the Exchange has proposed to adopt new CBOE Rule 6.13(b)(i)(C)(iii), which would prohibit members from entering or permitting the entry of multiple orders on the same side of the market in an option class within any 15-second period for an account or accounts of the same beneficial owner with respect to those orders eligible for submission pursuant to CBOE Rule 6.13(b)(i)(C)(ii).[5] The proposed rule change also would allow the appropriate floor procedure committee (''FPC'') to shorten the duration of this 15-second restriction by providing advance notice to the membership via a Regulatory Circular that is issued at least one day prior to implementation.

The Exchange also has proposed to limit to the scope of the rule. The Exchange has represented that while all of the floor-based options exchanges' rules, including CBOE Rule 6.8(e)(iii), broadly apply to all orders (*i.e.*, orders from customers and broker-dealers), the proposed amendment to CBOE Rule 6.13 will apply only to orders from options exchange market makers and stock exchange specialists, as defined in CBOE Rule 6.13(b)(i)(C)(ii).[6] According to the Exchange, customers and broker-dealers (as described in CBOE Rule 6.13(b)(i)(C)(i)) will not be subject to the rule and as such will continue to be eligible to receive unlimited automatic executions.

The Exchange clarified the scope of the proposed rule change in Amendment No. 1. Amendment No. 1 confirmed that Linkage Orders will not be subject to the proposed rule. Moreover, Amendment No. 1 proposed to amend the rule text to clarify the type of orders that will be presumed to be for the account(s) of the same beneficial owner. Specifically, the Exchange proposed that orders will be presumed to be for the account(s) of the same beneficial owner if they are not independently originated by separate market makers (or stock exchange specialists) and such orders clear into the same account or accounts with common ownership. The Exchange also included language that explained that the term ''independently originated'' means that a market maker (or stock exchange specialist) makes an individual determination to trade and separately communicates its trading determination (*i.e.*, order) to the Exchange.

Also in Amendment No. 1, the Exchange made representations regarding its members' ability to comply with the proposed rule. In this regard, the Exchange stated that it had contacted the large national market making firms, as well as the primary vendors used by the majority of market makers to submit quotes and orders, to gauge their ability to comply with the proposed rule. CBOE represented that, based on those discussions, it has determined that its members would be able to enforce compliance with the

[5] *See infra* note 6.

[6] On June 17, 2004, the Commission approved a proposed rule change that modified this paragraph. *See* Securities Exchange Act Release No. 49880, 69 FR 35086 (June 23, 2004) (SR–CBOE–2004–15). CBOE Rule 6.13(b)(i)(C)(ii) currently provides as follows:

(ii) (A) Options Exchange Market Makers: The appropriate FPC may also determine, on a class-by-class basis, to allow orders for the accounts of market makers or specialists on an options exchange (collectively ''options market makers'') who are exempt from the provisions of Regulation T of the Federal Reserve Board pursuant to Section 7(c)(2) of the Securities Exchange Act of 1934 to be eligible for automatic execution. The appropriate FPC may establish the maximum order size eligibility for such options market maker orders at a level lower than the maximum order size eligibility available to non-broker-dealer public customers and non-market maker or non-specialist broker-dealers. Pronouncements pursuant to this provision regarding options market maker access shall be made by the appropriate FPC and announced via Regulatory Circular.

(B) Stock Exchange Specialists: The appropriate FPC may determine, on a class-by-class basis, to allow orders for the account of a stock exchange specialist, with respect to a security in which it acts as a specialist, to be eligible for automatic execution in the overlying option class. The appropriate FPC may establish the maximum order size eligibility for such specialist orders at a level lower than the maximum order size eligibility available to options exchange market makers. Stock exchange specialists, with respect to orders in securities in which they do not act as specialist, will be treated as broker-dealers that are not market makers or specialists on an options exchange and will be eligible to submit orders for automatic execution in accordance with subparagraph (i) above.