subaccount) for the 2002 fiscal year. In addition, for twenty-four months following the substitutions, NLIC will not increase asset-based fees or charges for Contracts outstanding on the day of the proposed substitutions.

36. In addition to the prospectus disclosure (and supplements) distributed to owners of Contracts, within five days after the proposed substitutions, any Contract owners who were affected by the substitution will be sent a written notice informing them that the substitutions were carried out and that they may make one transfer of all accumulation or contract value under a Contract invested in any one of the affected subaccounts on the date of the notice to another subaccount available under their Contract without that transfer counting as one of a limited number transfers permitted in a Contract year free of charge. The notice will also reiterate the fact that NLIC will not exercise any rights reserved by it under any of the Contracts to impose additional restrictions on transfers until at least 30 days after the proposed substitutions. The notice as delivered in certain states also may explain that, under the insurance regulations in those states, Contract owners who are affected by the substitutions may exchange their Contracts for fixed-benefit life insurance contracts or annuity contracts, as applicable, issued by NLIC during the 60 days following the proposed substitutions. Current prospectuses for the new Funds will precede or accompany the notices.

37. NLIC also is seeking approval of the proposed substitutions from any state insurance regulators whose approval may be necessary or appropriate.

Applicants' Legal Analysis

1. The proposed substitutions appear to involve substitutions of securities within the meaning of section 26(c) of the Act.

2. Applicants state that the Contracts expressly reserve for NLIC the right, subject to compliance with applicable law, to substitute shares of one Portfolio or Fund held by a subaccount of an Account for another. The prospectuses for the Contracts and the Accounts contain appropriate disclosure of this right.

3. Applicants state that NLIC reserved this right of substitution both to protect themselves and their Contract owners in situations where either might be harmed or disadvantaged by circumstances surrounding the issuer of the shares held by one or more of their separate accounts and to afford the opportunity to replace such shares where to do so could benefit itself and Contract owners. The prospectuses for the Contracts and Accounts contain appropriate disclosure of this right.

4. In the case of the proposed substitutions, the MSF Portfolios would be replaced by funds with substantially similar investment objectives, and management would return to the investment management team which managed the MSF Portfolios prior to the reorganization in late 2000 (in the case of many of the Contract owners, the management team that was in place at the time they made the decision to allocate Contract value to the MSF Portfolios). The substitutions would also prevent Contract owners from being affected by any additional reorganization of MSF as it adapts to Nationwide's acquisition of PMLIC.

5. In addition to the foregoing, Applicants generally submit that the proposed substitutions meet the standards that the Commission and its staff have applied to similar substitutions that have been approved in the past.

6. Applicants anticipate that Contract owners will be at least as well off with the proposed array of subaccounts offered after the proposed substitutions as they have been with the array of subaccounts offered prior to the substitutions. The proposed substitutions retain for Contract owners the investment flexibility which is a central feature of the Contracts. If the proposed substitutions are carried out, all Contract owners will be permitted to allocate purchase payments and transfer accumulated values and contract values between and among the same number of subaccounts as they could before the proposed substitutions.

7. Applicants argue that each of the proposed substitutions is not the type of substitution which Section 26(c) was designed to prevent. Unlike traditional unit investment trusts where a depositor could only substitute an investment security in a manner which permanently affected all the investors in the trust, the Contracts provide each Contract owner with the right to exercise his or her own judgment and transfer accumulation and contract values into other subaccounts. Moreover, the Contracts will offer Contract owners the opportunity to transfer amounts out of the affected subaccounts into any of the remaining subaccounts without cost or other disadvantage. The proposed substitutions, therefore, will not result in the type of costly forced redemption which Section 26(c) was designed to prevent.

8. In addition, Applicants argue that the proposed substitutions are unlike the type of substitution which Section 26(c) was designed to prevent in that by purchasing a Contract, Contract owners select the specific type of insurance coverage offered by NLIC under their Contract as well as numerous other rights and privileges set forth in the Contract. Therefore, Applicants contend that Contract owners may also have considered NLIC's size, financial condition, type and its reputation for service in selecting their Contract. These factors will not change as a result of the proposed substitutions.

9. Applicants submit that, for all the reasons stated above, the proposed substitutions are consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–8811 Filed 4–9–03; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47628; File No. SR–CBOE–00–55]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 4 Thereto by the Chicago Board Options Exchange, Incorporated to Establish Rules for a Screen-Based Trading System Known as CBOE*direct*

April 3, 2003.

On November 9, 2000, 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 proposal to establish rules for a screen-based trading system known as CBOE*direct*. Subsequently, CBOE submitted three amendments to the proposed rule change.[3] On May 8,

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

[2] 17 CFR 240.19b–4.

[3] *See* letters from Angelo Evangelou, Legal Division, CBOE, to Nancy Sanow, Division of Market Regulation, Commission, dated October 25, 2001 (''Amendment No. 1''); April 1, 2002 (''Amendment No. 2''); and April 18, 2002 (''Amendment No. 3''). Amendment No. 1 superceded the original submission in its entirety and made substantial changes to the proposed rule

Continued

2002, the Commission published the amended proposal in the **Federal Register**.[4] The Commission received no comments on the proposal. On March 14, 2003, CBOE submitted a fourth amendment to the proposal.[5] This notice and order solicits comment on Amendment No. 4 and approves the proposal, as amended, on an accelerated basis.[6]

I. Description of the Proposal

The Exchange proposed rules governing CBOE*direct*, a screen-based trading system (''SBT System'') that allows market participants to trade options in a wholly electronic environment. CBOE*direct* will supplement the Exchange's floor-based open outcry auction market. Many of CBOE's existing rules also will apply to CBOE*direct;* CBOE provided a list of these rules as Appendix A to the proposed rule change.[7] CBOE also has proposed a number of new rules that would govern the SBT System.

The Exchange commenced operating CBOE*direct* as a pilot trading system in October 2001 pursuant to rule 19b–5 under the Act[8] and currently is used to trade three classes of index options during an early morning session. CBOE*direct* is designed, however, to handle a full range of products that currently trade on CBOE's floor.

A. Overview of CBOEdirect

Any CBOE member that chooses to participate on the SBT System must apply with the Exchange to act as an SBT market maker, SBT broker, or proprietary trader (collectively, ''SBT traders'').[9] An SBT trader may connect to CBOE*direct* from any place in the United States where it has a workstation and communication link to the Exchange.[10] Orders may be submitted through the current wire order facility (used to send orders to the Exchange's open-outcry auction market), an SBT workstation, or a computer-to-computer link using a new application program interface (''API''). Any SBT trader may submit an order to CBOE*direct;* only an SBT market maker may enter quotes.[11] The SBT System provides SBT traders with the means to electronically hit a bid or take an offer, resulting in either a full or partial execution of the existing bid or offer.[12]

A concept central to the operation of CBOE*direct* is the ''legal width market.'' A legal width market would exist in an option series if the best bid and the best ask available on the SBT System were within a prescribed width.

These widths are as follows:

Bid range	Maximum allowable quote spread
Less than $2.00	$0.25
$2.00–$5.00	0.40
$5.01–$10.00	0.50
$10.01–$20.00	0.80
$20.01–higher	1.00

A legal width market on CBOE*direct* may be established by an unrelated bid and offer. *See* CBOE rule 44.4(b). The appropriate Market Performance Committee may widen the legal width market for one or more option series for a period of time not to exceed the remainder of the existing expiration cycle. *See* CBOE rule 44.4(e). If the committee were to modify the legal width market, an information circular would be issued to provide notice of such modification. *See id.*

The legal width market feature is designed to prevent executions from occurring at unfair or unreasonable prices. For example, a market order for a particular option series would execute immediately only if a legal width market existed in that series at the moment the order was entered. If a legal width market in that series did not exist when the market order was entered, the SBT System would generate a request for quote (''RFQ'')[13 14] in an effort to establish a legal width market.

CBOE*direct* would send the RFQ to: (1) SBT market makers who are logged on to the SBT system and who hold an appointment in the subject option class; and (2) any non-appointed SBT market maker who is quoting in that class at the time of the RFQ. The market makers' responses (*i.e.*, quotes) would be submitted to the SBT book and displayed as they arrived. If the responses were not sufficient to establish a legal width market, the System would continue to hold the market order, repeat the RFQ cycle, and send an alert message to the Help Desk, which then could solicit quotes from the SBT market makers.[15] The Help Desk would have the authority to send a Special RFQ to the SBT market makers that would require a response.[16] However, assuming that the RFQ responses created a legal width market, the order being held by the System would execute in a manner described in section I.H.1. below.

When the SBT System eventually is so enabled, CBOE*direct* would similarly protect a marketable limit order for an options series for which a legal width market did not exist at the time of order entry by running the RFQ cycle before attempting to execute the limit order. Presently, however, a limit order would execute immediately if the limit order were marketable on the SBT book, even if a legal width market did not exist. A fuller description of limit order processing is contained in section I.H.2. below.

CBOE anticipates that, during regular trading hour (''RTH'') sessions,[17]

text and the accompanying narrative. In Amendment No. 2, CBOE revised the proposed trade nullification rule for CBOE*direct*. In Amendment No. 3, CBOE further modified the proposed trade nullification rule.

[4] *See* Securities Exchange Act Release No. 45829 (April 25, 2002), 67 FR 31002 (''Notice'').

[5] *See* letter from Angelo Evangelou, Legal Division, CBOE, to Nancy Sanow, Division of Market Regulation, Commission, dated March 13, 2003 (''Amendment No. 4''). For the matters addressed in Amendment No. 4, *see infra* section III.

[6] In addition, CBOE submitted a letter to the Division of Market Regulation requesting interpretive guidance under section 11(a) of the Act, 15 U.S.C. 78k(a), and rule 11a2–2(T) thereunder, 17 CFR 240.11a2–2(T). *See* letter from Angelo Evangelou, Legal Division, CBOE, to Catherine McGuire, Division of Market Regulation, Commission, dated March 28, 2003. In response to CBOE's request, staff of the Division of Market Regulation provided interpretive guidance under section 11(a) of the Act. *See* letter from Paula R. Jenson, Division of Market Regulation, Commission, to Angelo Evangelou, Legal Division, CBOE, dated March 31, 2003.

[7] *See* notice, *supra* note 4, 67 FR at 31016–22 (listing the existing Exchange rules in chapters I through XXVII that would apply to CBOE*direct* and indicating those rules that would be supplemented by the CBOE*direct* rules). In Amendment No. 4, CBOE made several revisions to Appendix A.

[8] 17 CFR 240.19b–5. Rule 19b–5 provides that a self-regulatory organization (''SRO'') may operate a pilot trading system without obtaining prior Commission approval for the rules governing such system, provided that the SRO files a Form PILOT with the Commission and meets the other criteria set forth in rule 19b–5. On September 7, 2001, CBOE filed with the Commission a Form PILOT with respect to CBOE*direct*. An SRO may commence operation of a pilot trading system no sooner than 20 days after filing its Form PILOT. See 17 CFR 240.19b–5(e)(1). CBOE commenced operation of the SBT System on October 26, 2001. Rule 19b–5 requires an SRO, within two years of commencing operations of the pilot trading system, to file a proposed rule change pursuant to section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2), to obtain permanent authority to operate that system. *See* 17 CFR 240.19b–5(f)(1). The proposed rule change that is the subject of this Order was submitted pursuant to that requirement.

[9] *See* CBOE rule 41.2.

[10] *See* CBOE rule 41.3.

[11] Other SBT traders would be prohibited from entering limit orders in the same options series, for the account or accounts of the same or related beneficial owners, in such a manner that the order provider or the beneficial owner(s) effectively would be operating as a market maker by holding itself out as willing to buy and sell option contracts on a regular or continuous basis. *See* CBOE rule 43.6(c).

[12] *See* notice, *supra* note 4, 67 FR at 31037–38.

[13 14] See CBOE rule 40.1(m).

[15] *See* CBOE rule 43.7(b).

[16] *See id.;* CBOE rule 40.1(n).

[17] *See* CBOE rule 40.1(*l*) (definition of ''regular trading hour session'').

multiple SBT market makers would continuously quote actively traded products, while less actively traded products would be quoted through the RFQ process.[18] The Exchange indicated, however, that when the SBT System is used during an extended trading hour (''ETH'') session, most products likely would be quoted through RFQs.[19]

B. Market Participants

1. Market Makers

An SBT market maker is a CBOE member who is either an SBT standard market maker, an SBT designated primary market maker (''DPM''), or an SBT lead market maker (''LMM''). An applicant for registration as an SBT market maker must file an application with the Exchange's Membership Department; the Exchange's Membership Committee may approve or disapprove the applicant's registration as an SBT market maker.[20] A registered SBT market maker may apply for an appointment in one or more classes of option contracts traded on CBOE*direct*. The appropriate Market Performance Committee may arrange two or more classes of options into groupings and make appointments to those groupings rather than to individual classes. The appropriate Market Performance Committee may suspend or terminate any appointment of an SBT market maker or make additional appointments whenever, in the Committee's judgment, the interests of a fair and orderly market would best be served by such action.[21]

With respect to each class of options for which it holds an appointment, an SBT market maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for its own account when there exists or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. An SBT market maker is expected to perform the following activities in the course of maintaining a fair and orderly market:

- Competing with other SBT market makers to improve markets in all series of options class in which the SBT market maker holds an appointment;
- Making markets which, absent changed market conditions, will be honored for the number of contracts entered into the SBT System in all series of options classes in which the SBT market maker holds an appointment; and
- Updating market quotations in response to changed market conditions in all series of options classes in which the SBT market maker holds an appointment.[22]

In addition, at least 75% of an SBT market maker's total contract volume on CBOE*direct* must be in options classes in which it holds an appointment.[23]

Furthermore, SBT market makers are required to respond to a certain percentage of RFQs that they receive. The appropriate Market Performance Committee has the authority to determine the percentage of RFQs to which an SBT standard market maker would be required to respond, which percentage may not be less than 75%,[24] and may vary the RFQ response rate on a series-by-series basis.[25] SBT DPMs and LMMs are subject to higher requirements and must respond to 98% of the RFQs that they receive.[26] An SBT market maker would be credited for an RFQ response only if: (1) The SBT market maker responds to the RFQ with a two-sided market within a number of seconds designated by the appropriate Market Performance Committee; (2) the quote width is equal to or narrower than a legal width market; [27] (3) the quote size is at least equal to the minimum size specified by the appropriate Market Performance Committee and in any case is at least five contracts; and (4) the SBT market maker provides a continuous market for 30 seconds, or the quote is filled before the 30-second period expires.[28] The SBT market maker could change its quote during this period but could not cancel it to receive credit for the response.[29]

On CBOE*direct*, a market maker may also be a designated primary market maker (''DPM'') or a lead market maker (''LMM''). The Exchange's SBT DPM Committee may assign an SBT DPM to a particular option class.[30] Different members could be assigned to be the SBT DPM for the same option class during different trading sessions.[31] If the SBT DPM Committee does not appoint an SBT DPM in a given class, the appropriate Market Performance Committee could appoint one or more SBT LMMs.[32] If more than one SBT LMM is appointed, they would function as the SBT LMM on a rotating basis in accordance with a schedule set by the appropriate Market Performance Committee.[33] SBT LMMs would have responsibilities similar to SBT DPMs.[34]

The obligations of SBT DPMs and LMMs are greater than those of SBT standard market makers.[35] SBT DPMs and LMMs are obligated, for example, to provide opening quotes for all series in their allocated classes.[36] The appropriate Market Performance Committee also could require that an SBT DPM or LMM provide continuous quotations in some or all of the series of its appointed classes.[37] Furthermore, SBT DPMs and LMMs are required to handle public customer orders that are not executed on the System due to the fact that there is a better quote on another exchange, and to accord priority to such public customer orders over their own principal transactions (unless the customer who placed the order has consented to not being accorded such priority).[38]

2. Brokers

An SBT broker is an individual (either a member or a nominee of a member organization) who is registered with the Exchange for the purpose of accepting and executing on CBOE*direct* orders

[18] *See* notice, *supra* note 4, 67 FR at 31038.

[19] In addition, the appropriate SBT Trading Committee may determine to limit the kinds of orders that may be traded during an ETH session, even if such order types may be traded during an RTH session. *See* CBOE rule 43.2(b). CBOE has represented that it would distribute an information circular indicating any committee determination to limit the order types that may be traded during an ETH session. Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Elizabeth King, Division of Market Regulation, Commission, on June 21, 2002 (''June 21 conversation'').

[20] *See* CBOE rule 44.2(a).

[21] *See* CBOE rule 44.3(a).

[22] *See* CBOE rule 44.4(a)(1). In Amendment No. 4, the Exchange clarified SBT market makers' obligations by incorporating into CBOE rule 44.4(a)(1) the provisions of its existing CBOE rule 8.7 (setting forth market makers' obligations on the Exchange floor), modified to take into account differences between making markets on a physical floor and on an electronic platform.

[23] *See* CBOE rule 44.4(a)(2).

[24] *See* CBOE rule 44.4(b). The response rate would be computed as the number of times the SBT market maker made a credited response, divided by the number of RFQs to which the market maker was obligated to respond. *See* notice, *supra* note 4, 67 FR at 31039. In addition, the appropriate Market Performance Committee could, depending on the liquidity in any of the underlying markets during an ETH session, determine not to impose an RFQ response requirement, or impose an RFQ response rate lesser than the one applicable during regular trading hours. *See* CBOE rule 44.4(d).

[25] *See* CBOE rule 44.4(e).

[26] *See* CBOE rules 44.4, Interpretation .01(a)(4) and 44.14(a)(4).

[27] *See supra* note 13.

[28] *See* CBOE rule 44.4(b).

[29] *See id.*

[30] *See* CBOE rule 44.12.

[31] *See* CBOE rule 44.16.

[32] *See* CBOE rule 44.3, Interpretation .01.

[33] *See id.*

[34] *See* CBOE rule 44.4, Interpretation .01(a).

[35] *See* CBOE rule 41.1(a)(2).

[36] *See* CBOE rules 44.4, Interpretation .01(a)(2) and 44.14(a)(2).

[37] *See id.*

[38] *See* CBOE rules 44.14(b)(6) and 44.4, Interpretation .01(a)(6).

received from members, registered broker-dealers, or public customers. As with brokers operating in the Exchange's open-outcry auction market, an SBT broker would not be permitted to accept an order from any source other than a member or a registered broker-dealer, unless he or she were approved to transact business with the public in accordance with CBOE rule 9.1.[39]

SBT brokers would have the same obligations as brokers on the Exchange's auction market to use due diligence in the representation of orders for which they act as agent. SBT brokers may use an SBT workstation or an API to enter, cancel, cancel/replace, and maintain orders; hit bids and take offers; submit RFQs; and enter cross notifications and proposed cross orders.

3. Proprietary Traders

A proprietary trader is a CBOE member who enters orders as principal for a non-market-maker proprietary account.[40] A proprietary trader may use an SBT workstation or an API to enter, cancel, cancel/replace, and maintain orders; hit bids and take offers; and submit RFQs.

4. Clearing Firm Brokers

A clearing firm broker is an individual who represents the clearing firm of a particular SBT market maker and has the authority to take certain actions with respect to that market maker's use of the SBT System.[41] A clearing firm broker may request the CBOE Help Desk to force the logout of an SBT trader when, for example, that trader has financial difficulty. In addition, the forced logout of an SBT trader could be necessary if technical difficulties prevented the trader from logging off on his or her own.

C. Priority

The proposed CBOE*direct* rules do not prescribe a single allocation methodology. Instead, the rules give the appropriate SBT Trading Committee authority to apply various allocation priorities. CBOE has represented that it would issue a regulatory circular specifying the allocation rules that would govern each option class.[42]

There would be two basic types of trade allocation methodologies:

• *Price-Time Priority.* Under this method, resting orders in the SBT book would be prioritized according to price and time. If two or more orders were at the best price, priority among these orders would be afforded in the sequence in which they were received by the System.[43]

• *Pro Rata Priority.*[44] Under this method, resting orders in the SBT book would be prioritized according to price. If there were two or more orders at the best price, trades would be allocated proportionally according to their size.[45] The executable quantity would be allocated to the nearest whole number, with fractions one-half or greater rounded up and fractions less than one-half rounded down.[46]

In addition to these allocation methodologies, the appropriate SBT Trading Committee could determine to overlay, on a class-by-class basis and in any order, any or all of the following additional market participant priorities (''priority overlays''):[47]

1. *Public Customer.* If this were the only priority overlay in effect, the highest bid and lowest offer would have priority, except that a public customer order would have priority over a non-public customer order at the same price. If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate SBT Trading Committee. In either case, if there were two or more public customer orders for the same option series at the same price, priority would be afforded to these orders in the sequence in which they had been received by the System, even if the *pro rata* allocation method were the designated allocation method. For purposes of this provision, a ''public customer order'' is an order for an account in which no CBOE member, non-member participant in a joint venture with a member, or non-member broker-dealer (including a foreign broker-dealer) has an interest.[48]

2. *Market Turner.* The ''market turner'' is the SBT trader who is the first to enter an order or quote at a better price than the previous best book price, and the order or quote was continuously in the market until it traded.[49] If market turner priority were the only priority overlay in effect, the market turner would have priority at the highest bid or lowest offer that it had established. If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate SBT Trading Committee. In either case, market turner priority at a given price would remain with the order once it had been earned. For example, if the market moved in the same direction as the marker turner had moved the market, and then the market moved back to the market turner's original price, the market turner would retain priority at the original price.

3. *Trade Participation Right.* SBT DPMs and LMMs may be granted a trade participation right to trade against up to 40% of an incoming order,[50] even though the order and/or quote of the SBT DPM or LMM do not have the highest priority. If other priority overlays were also in effect, priority would be established in the sequence designated by the appropriate SBT Trading Committee. All of the following conditions would apply to the SBT DPM or LMM trade participation right:

• The order and/or quote of the SBT DPM or LMM must be at the best price.[51]

• An SBT DPM or LMM may not be allocated a total quantity greater than the quantity than it was quoting at that price.[52]

• If pro rata priority is in effect and the SBT DPM's or LMM's allocation of an order pursuant to its trade participation right is greater than its percentage share of the quotes/orders at the best price at the time that the trade participation right is granted, the SBT DPM or LMM may not receive any further allocation of that order.[53]

• If the trade participation right priority overlay and the market turner priority overlay are both in effect and the SBT DPM or LMM were the market turner, market turner priority would not apply.[54]

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[39] *See* CBOE rules 41.1(a)(5) and 45.1.

[40] *See* CBOE rule 41.1(a)(6).

[41] *See* CBOE rule 45.11.

[42] *See* notice, *supra* note 4, 67 FR at 31026.

[43] *See* CBOE rule 43.1(a)(1). For examples of how the price-time allocation method would operate, *see* notice, *supra* note 4, 67 FR at 31027–28.

[44] In Amendment No. 4, CBOE changed the name of this allocation methodology from ''combined price-time and size priority'' to ''*pro rata* priority.''

[45] *See* CBOE rule 43.1(a)(2). For examples of how this allocation method would operate, *see* notice, *supra* note 4, 67 FR at 31028–31.

[46] If there were two SBT traders that were both entitled to an additional one-half contract and there were only one contract remaining to be distributed, the additional contract would be distributed to the SBT trader whose quote or order had time priority. *See* CBOE rule 43.1(a)(2).

[47] *See* CBOE rule 43.1(b).

[48] *See* CBOE rule 43.1(b)(1).

[49] *See* CBOE rule 40.1(i).

[50] *See* CBOE rules 43.1(b); 44.4, Interpretation .01(b); and 44.15. However, the participation of an SBT DPM or LMM in an order may exceed 40%, depending on the allocation rules in effect. *See id.* Assume, for example, that price-time priority is in effect. An SBT DPM or LMM could receive up to 40% of an incoming order due to its trade participation right, then receive an additional portion of the incoming order if it has an order or quote on the SBT book that has the highest time priority at the best price. If *pro rata* priority were in effect, an SBT DPM or LMM could receive up to 40% of an incoming order due to its trade participation right, then receive an additional portion of the incoming order if its percentage of the total volume being quoted at the best price exceeds 40%.

[51] *See* CBOE rule 43.1(b)(3)(A).

[52] *See* CBOE rule 43.1(b)(3)(B).

[53] *See id.*

[54] *See* CBOE rule 43.1(b)(3)(C).

• If price-time priority were in effect and the SBT DPM or LMM had a quote and one or more orders at the same price, any contacts executed as part of the SBT DPM/LMM's trade participation right would trade with the highest priority quote/order(s) of the SBT DPM or LMM.[55]

• The trade participation right may not be in effect unless the public customer priority overlay is in effect in a priority sequence ahead of the trade participation right.[56] Thus, public customer orders at the best price would be executed before an SBT DPM or LMM trades by virtue of any trade participation right.

• If other priority overlays are in effect and designated as higher priorities than the SBT DPM or LMM trade participation right, the participation right would apply only to any remaining balance of an order after all higher priorities were satisfied.[57]

D. States of Trading

1. Pre-Opening

The pre-opening state would last for some period of time (as determined by the appropriate SBT Committee) before the opening of the underlying security.[58] During this state, CBOE*direct* would accept quotes and orders but no trading would take place.[59] The System would disseminate information about resting orders in the SBT book that remained from the prior business day and any orders and quotes sent before the opening.[60] After the primary market for the underlying security disseminates the opening trade or the opening quote for the underlying security, the System would send a notice to SBT market makers with an appointment in that class who then may submit their opening quotes.[61] The SBT DPM or LMM for that option class would be required to submit opening quotes.[62]

2. Opening

The SBT System would begin the opening procedure at a randomly selected time within a number of seconds after receiving the underlying security's opening price.[63] For some time after the notice of the underlying security's opening price is sent, the System would calculate and provide the expected opening price (''EOP'') based on the current resting orders and quotes during an EOP period.[64] The length of the EOP period would be established by the appropriate SBT Trading Committee and would be no less than five seconds and no more than one minute.[65] After the EOP period, the System would enter a lock interval during which quotes and orders could be submitted but would not be included in the opening trade. The lock interval would be a period of time not to exceed four seconds. At this time, the SBT System would establish the opening price, which would be the ''market clearing'' price that would leave bids and offers that could not trade with each other.

The System would process the series of a class in random order.[66] The series of a class may not open all at the same time. The System would not open a series if: (1) There were no legal width market; (2) the opening price were not within a range determined by the appropriate SBT Trading Committee (*e.g.*, the upper boundary of the acceptable range may be 125% of the highest quote offer and the lower boundary may be 75% of the lowest quote bid);[67] or (3) the opening trade would leave a market order imbalance.[68] If a series does not open, the System would commence the RFQ process in an effort to alleviate the conditions that caused the series not to open.[69]

As the opening price is determined by series, the System would change the product state of the series to ''trading'' and disseminate to OPRA and the SBT participants the opening quote and the opening trade price, if any.[70]

3. Trading

During this state, the series would trade freely. All order types and quotes would be accepted, except for opening-only contingency orders.[71]

4. Trading Halts

CBOE will use the same criteria to halt trading on CBOE*direct* that they use to halt trading on CBOE's floor.[72] In addition, the SBT System may be programmed (as determined by the appropriate SBT Trading Committee) to automatically halt trading with respect to an equity option if a trading halt has been declared for the underlying security in the primary market.[73] However, when the System is operated during an ETH session, there may not be a primary market trading the underlying security. In such cases, the appropriate SBT Trading Committee would determine in advance whether to have the System automatically halt trading with respect to the options if there is no primary market for the underlying security in the ETH session and if trading in the underlying security has been halted in another market trading the underlying security during an ETH session.[74] Whenever trading has been halted, trading may be resumed whenever two trading officials determine that a fair and orderly market may be maintained.[75]

5. Closed

CBOE*direct* would change the state to ''closed'' at a pre-determined time depending on the closing time of the

[55] *See* CBOE rule 43.1(b)(3)(D).

[56] *See* CBOE rule 43.1(b)(3)(E).

[57] *See* CBOE rule 43.1(b)(3)(F).

[58] *See* CBOE rule 42.3(a). CBOE has represented that it would distribute an information circular indicating the pre-opening period of time that it establishes. June 21 conversation.

[59] *See* CBOE rule 42.2(a). However, spread orders and contingency orders (except for opening-only orders) would not participate in the opening or in the determination of the opening price. *See* CBOE rule 42.3(a). CBOE has represented that it would distribute an information circular indicating the pre-opening period of time that is established by the Exchange. June 21 conversation.

[60] *See id.* CBOE could determine to disseminate this information for free to any SBT trader interested in trading the product. Alternately, CBOE could determine to impose a fee for such information. In the latter case, the fee proposal would have to be filed with the Commission pursuant to section 19(b) of the Act, 15 U.S.C. 78s(b). Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Nancy Sanow and Michael Gaw, Division of Market Regulation, Commission, on October 23, 2002 (''October 23 conversation'').

[61] *See* CBOE rule 42.3(a).

[62] *See id.* SBT standard market makers generally would not be required to provide opening quotes, except in the circumstances described in proposed CBOE rule 42.3(b).

[63] *See* CBOE rule 42.3(a). In the case of trading during an ETH session, the System could open the class without having received the underlying security's opening price. *See id.*

[64] *See* CBOE rule 42.3(c).

[65] *See id.* CBOE has represented that it would distribute an information circular indicating the period that is established by the Committee. June 21 conversation.

[66] *See* CBOE rule 42.3(d).

[67] CBOE has stated that this provision is designed to prevent orders that rest on the SBT book between sessions from being executed at a price far from the prevailing quote at the opening of the next session. Telephone call between Angelo Evangelou, Legal Division, CBOE, and Michael Gaw, Division of Market Regulation, Commission, on December 9, 2002. CBOE has represented that it would publicize the range set by the committee in an information circular. *Id.*

[68] *See* CBOE rule 42.3(f).

[69] *See* CBOE rule 42.3(g). The RFQ generated by the SBT System in this case would include size. The RFQs generated by the System in market and limit order processing also would include size. October 23 conversation.

[70] *See* CBOE rule 42.3(e).

[71] *See* CBOE rule 42.2(c).

[72] Specifically, CBOE rules 6.3, 6.3B, or 24.7 will apply to trading on CBOE*direct*. *See* Appendix A. Originally, CBOE proposed that new, different provisions would govern trading halts on the SBT System. In Amendment No. 4, CBOE deleted most of these proposed provisions and instead proposed to apply existing CBOE rule 24.7 to trading halts on CBOE*direct*.

[73] *See* CBOE rule 43.4(b). The System would send status alerts to OPRA for a product that is halted. *See* notice, *supra* note 4, 67 FR at 31025.

[74] *See* CBOE rule 43.4(b).

[75] *See id.*

underlying security. Trading would cease but the System would continue to accept certain order types (such as market orders, which would be held by the System for participation in the opening of the next SBT session).[76] At some designated time, as determined by the Exchange, the System would stop accepting orders and would enter into end-of-session procedures as described in CBOE rule 42.4.[77]

6. Fast Markets and Non-Firm Markets

A fast market may be declared in one or more option classes. A fast market may be declared by the System automatically if the System loses an underlying security feed.[78] A fast market also may be declared by two trading officials whenever, in their judgment, an influx of orders or other conditions or circumstances would impair the operation of a fair and orderly market. In determining whether to declare a fast market, the trading officials may consider, among other things, impending news, increases in trading volume that threaten the capacity of the System, and the loss of an underlying security feed.[79] Regular trading conditions may be resumed when two trading officials believe that such action is warranted or, if the System had made the fast market declaration, if the underlying security feed has been restored.[80]

CBOE may designate the market in an option to be ''non-firm'' if two trading officials determine that the level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the option in a manner that accurately reflects the current state of the market on CBOE*direct*. If a market is declared non-firm, the Exchange would provide notice that its quotations are not firm by appending an appropriate indicator to such quotations, and two trading officials would have the authority to direct that one or more trading rotations be employed or to take such other actions as are deemed necessary in the interest of maintaining a fair and orderly market. The Exchange would monitor the activity or conditions that caused the declaration of a non-firm market, and two trading officials would be required to review the condition of such market at least every 30 minutes. Regular trading procedures would be resumed by the Exchange when two trading officials determined that the conditions supporting a non-firm market declaration no longer existed. The Exchange would provide notice that its quotations were once again firm by removing the indicator from its quotations. However, if the conditions supporting a non-firm market declaration could not be managed utilizing the prescribed procedures, two trading officials would halt trading in the class or classes so affected.[81]

There is a significant difference between a ''non-firm'' market and a fast market: Only in a non-firm market would responsible brokers and dealers be relieved of their obligations under the Exchange's firm quote rule, as applicable to CBOE*direct,*[82] and the Commission's firm quote rule.[83] In a fast market that is not also a non-firm market, the firm quote obligations would continue to apply.

E. Firm Quote Obligations on CBOE*direct*

Each responsible broker or dealer, as defined in rule 11Ac1–1 under the Act,[84] must communicate to the Exchange its bids and offers in accordance with rule 11Ac1–1, and a bid or offer submitted by a responsible broker or dealer must be firm pursuant to rule 11Ac1–1 for the number of contracts specified in such bid or offer, subject to certain exceptions.[85] A responsible broker or dealer would be relieved of its firm quote obligations under rule 11Ac1–1 and Exchange rules if any of the following conditions existed:[86]

• The level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the option in a manner that accurately reflects the current state of the market on the Exchange and, as a result, the market in the option is declared to be ''non-firm'' pursuant to CBOE rule 43.14(b);

• A system malfunction or other circumstance impairs the Exchange's ability to disseminate or update market quotes in a timely and accurate manner;

• A trading rotation is in progress; or

• Any of the circumstances set forth in paragraph (c)(3) of rule 11Ac1–1[87] exists.

Within 30 seconds of receipt of an order to buy or sell an option series in an amount greater than the size associated with the responsible broker's or dealer's bid or offer, that portion of the order equal to the size associated with the responsible broker's or dealer's bid or offer will be executed, and the bid or offer price will be revised.[88]

F. Trade Nullification

The SBT System rules provide for the ability to nullify a trade through a negotiated or mandated trade nullification procedure.

1. Negotiated Trade Nullification

A CBOE*direct* trade could be nullified if both parties to the transaction agreed to the nullification.[89] Negotiation could be conducted through the SBT System's messaging facility that would allow a party to exchange messages with its contraparty of a particular trade. The System would preserve the anonymity of the parties, although one party could voluntarily disclose its identity to the other party. When both parties to a trade have agreed to a trade nullification, one party must contact the Help Desk. The Help Desk then would confirm the agreement and promptly nullify the trade, notify the parties involved, disseminate cancellation information in prescribed OPRA format, and re-establish orders and their priorities in the SBT book on a best-efforts basis.

2. Mandated Trade Nullification

An SBT trader may have a trade nullified by two trading officials if a documented request is made within five minutes of execution (or 15 minutes if the request is on behalf of a public customer) and one of five following conditions is met:

• The trade resulted from a verifiable disruption or malfunction of an Exchange execution, dissemination, or communication system that caused a quote/order to trade in excess of its disseminated size (*e.g.*, a quote/order that is frozen, because of an Exchange system error, and traded repeatedly);[90]

[76] *See* CBOE rule 42.2(e).

[77] *See id.* CBOE has represented that it would issue an information circular regarding the designated time that the SBT System would stop accepting orders and enter into end-of-session procedures. December 5 conversation.

[78] *See* CBOE rule 43.4(a)(1).

[79] *See* CBOE rule 43.4(a)(2).

[80] *See* CBOE rule 43.4(a)(1)–(2).

[81] *See* CBOE rule 43.14(b).

[82] CBOE rule 43.14(a).

[83] 17 CFR 240.11Ac1–1.

[84] 17 CFR 240.11Ac1–1.

[85] *See* CBOE rule 43.14(a). The Commission notes that an SBT market maker is permitted to display a single quote and one or more orders at the same time. All orders and quotes of a responsible broker or dealer that are displayed on CBOE*direct* will be subject to the Commission's Firm Quote rule.

[86] *See* CBOE rule 43.14(c)(1).

[87] 17 CFR 240.11Ac1–1(c)(3)

[88] *See* CBOE rule 43.14(c)(2).

[89] *See* CBOE rule 43.5(a).

[90] *See* CBOE rule 43.5(b)(1). For example, assume that an SBT market maker enters a quote of 4.00–4.30, 20x20. Another SBT trader hits the market maker's bid at 4.00 for the full size of 20 contracts. Also assume that the SBT System fails to remove the market maker's bid from the SBT book, even

• The trade resulted from a verifiable disruption or malfunction of an Exchange dissemination or communication system that prevented an SBT trader from updating or canceling a quote/order for which the SBT trader is responsible, where there is Exchange documentation providing that the SBT trader sought to update or cancel the quote/order; [91]

• The trade resulted from an erroneous print disseminated by the underlying market that is later canceled or corrected by that underlying market, where the erroneous print resulted in a trade higher or lower than the average trade in the underlying security during the two-minute time period before and after the erroneous print by an amount at least five times greater than the average quote width for the underlying security during the time period encompassing two minutes before and after the erroneous print;[92]

• The trade resulted from an erroneous quote in the primary market for the underlying security that has a spread of at least $1.00 and at least five times greater than the average quote width for the underlying security during the time period encompassing two minutes before and after the dissemination of such quote; [93] or

• The execution price of the trade is higher or lower than the theoretical price for the series by an amount equal to at least two times the maximum bid/ask spread allowed for the option under proposed CBOE rule 44.4, so long as such amount is $0.50 or more (or $0.25 or more for options priced under $3.00).[94]

Upon nullification, the Help Desk promptly would notify the parties, disseminate cancellation information in prescribed OPRA format, and re-establish orders and their respective priorities on the SBT book on a best-efforts basis.[95]

Any determinations made under the trade nullification rule could be appealed pursuant to chapter 19 of the Exchange's rules.[96]

G. How Trades Are Executed on CBOEdirect

1. Market Orders

a. Market Order Processing

Non broker-dealer market orders to buy or sell options on CBOE*direct* will not be automatically executed by the System at prices inferior to the best bid or offer on another national securities exchange, as those best prices are identified by the System.[97] In addition, the SBT System would protect a market order for a given option series by executing it against the best bid or offer only if there were a legal width market in that series.[98] The System would match market orders against orders at the best price in the SBT book and against the other orders behind the best price at varying prices until the order is fully executed or a legal width market no longer exists.[99] CBOE expects that there would be a legal width market for most series at most times—at least during an RTH session—and thus that most market orders on CBOE*direct* would execute immediately.[100]

If there is no legal width market when the order is entered—or if the market order is not executed in full because a legal width market no longer exists—the System would hold the order (or any remaining portion thereof) in queue, send an RFQ,[101] and inform the originator of the market order about the order's status.[102] In this case, the RFQ would include the market order quantity but not whether the order was a buy or a sell.[103] RFQ responses would be sent to the SBT book.[104] The System then would execute the market order if:

• During the RFQ response time, the best quote becomes a certain prescribed percentage (as set by the appropriate SBT Trading Committee) of a legal width market; [105]

• The System receives a limit order on the same side of the market as the market order that could match the best bid or offer and at least one legal width quote has been received; [106] or

• A certain prescribed percentage of the SBT market makers currently providing quotes in the class (the percentage to be set by the appropriate SBT Trading Committee) respond to the RFQ with legal width markets.[107]

If the market order could be executed under any of the three conditions above and there is a market order on the opposite side, the System would execute the market orders with each other.[108]

If none of the three conditions noted above were satisfied but a legal width market existed at the end of the RFQ period, the market order would execute against the booked order with the highest priority.[109] However, if the System were holding a market order and the RFQ process did not yield a legal width market, the Exchange's Help Desk could solicit quotes and require a response from SBT market makers.[110]

b. Market Order Price

If a market order is executed before the RFQ process is completed under any of the three conditions set forth above, it would trade at the price of the highest priority contraside quote or order in the SBT book. However, if a market order could be executed pursuant to any of the three conditions and there were one or more market orders on the opposite side, the System would execute the market orders against each other at a price determined as follows: [111]

• At the middle of the best bid/offer in the SBT book, if the middle price is a price that may be entered on the System; or

• If the middle price is not a price that could be entered on the System, at the next such price that is closer to the last trade price for the series.

though it has been taken out completely. A second SBT trader sees the ''frozen'' bid for 20 at 4.00 and also trades against it. In this case, the second trade could be nullified under CBOE rule 43.5(b)(1). Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Nancy Sanow, Division of Market Regulation, Commission, on February 20, 2003 (''February 20 conversation'').

[91] *See* CBOE rule 43.5(b)(2).

[92] *See* CBOE rule 43.5(b)(3).

[93] *See* CBOE rule 43.5(b)(4).

[94] *See* CBOE rule 43.5(b)(5). The theoretical price of an option would be defined as the last bid/offer price, just prior to the trade, from the exchange providing the most volume in the option or, if there are no quotes for comparison, the theoretical price would be determined by two trading officials. *See id.*

[95] *See* CBOE rule 43.5(b).

[96] *See id.*

[97] *See* CBOE rule 43.7.

[98] *See* CBOE rule 43.7(a)(1).

[99] *See* id.

[100] *See* notice, *supra* note 4, 67 FR at 31033 n.26.

[101] The RFQ would be sent to any SBT market maker who held an appointment in that option class and to any non-appointed SBT market maker who is quoting in that option class at the time the RFQ is sent. *See* CBOE rule 40.1(m).

[102] *See* CBOE rule 43.7(a)(2).

[103] *See* CBOE rule 43.7(a)(3). The only instance that an RFQ would disclose whether the intended transaction is a buy or a sell is if the SBT System generated an RFQ to remedy an order imbalance. October 23 conversation.

[104] *See* CBOE rule 43.7(a)(3). Also, market orders generally have execution priority over limit orders. However, a limit order may be executed ahead of the market order if, during the pendency of an RFQ, an order is entered on the other side of the market that satisfies the order's limit price. *See* CBOE rule 43.1(g).

[105] *See* CBOE rule 43.7(a)(3)(A). CBOE has represented that it would issue an information circular regarding the designated percentage that would trigger this provision. December 5 conversation. The market order would trade with the best-priced quote or order on the SBT book.

[106] *See* CBOE rule 43.7(a)(3)(B). The market order would trade with the best priced quote or order on the SBT book. However, if no legal width market existed at the time the limit order were received, the incoming limit order would execute ahead of the market order. *See id.;* CBOE rule 43.1(g).

[107] *See* CBOE rule 43.7(a)(3)(C).

[108] *See* CBOE rule 43.7(a)(4).

[109] Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Michael Gaw, Division of Market Regulation, Commission, on September 25, 2002.

[110] *See* CBOE rule 43.7(b).

[111] *See* CBOE rule 43.7(a)(4).

If one or more incoming RFQ responses could execute against a market order as well as any limit orders that were already on the SBT book at a particular price and the incoming responses are of large enough quantity to fill all of the older limit orders, all of those orders would be filled at the price of the older limit orders.[112] If the responses could execute against a market order and one or more older limit orders, but the responses are not of large enough quantity to fill all of the older limit orders, the market order would be filled at the minimum price interval ahead of the older limit orders.[113]

c. Market Orders During Trading Halts

If trading were halted in a series while a market order for an option in that series were on hold waiting for RFQ responses, CBOE*direct* would operate as follows:

- If the market order were a good-'til-canceled order, the System would hold and execute it at the next opening (whether on the same day or the next day).
- If the market order were a day order, the System would execute it at re-opening if trading resumed on the same day.
- If trading did not resume on the same day, the System would purge the market order as part of the end-of-day procedures.[114]

2. Limit Order Processing

Non-broker-dealer marketable limit orders to buy or sell options on CBOE*direct* will not be automatically executed by the System at prices inferior to the best bid or offer on another national securities exchange, as those best prices are identified in the System.[115] Broker-dealer limit orders, non-broker-dealer limit orders that are not marketable, and limit orders in options that are not traded on another national securities exchange will be processed as follows.

As presently configured, CBOE*direct* will process limit orders by matching them against the best prices available in the SBT book under the priority rules set forth in CBOE rule 43.1. If no booked order matched the incoming limit order, the limit order would be held in the SBT book and could trade against later-submitted orders.[116]

In the future, CBOE*direct* will be enabled to provide additional protection for limit orders by allowing a limit order to be executed only if there is a legal width market in that series.[117] If a legal width market did not exist but the limit order could otherwise execute against the best bid or offer, the System would put the order in queue and send an RFQ.[118] The RFQ would include the order quantity but not whether the order was a buy or sell. Quote responses would be exposed in the SBT book as they were received. The System would execute the limit order if:

- During the RFQ response time, the best quote becomes a certain prescribed percentage (*e.g.*, 75%, as set by the appropriate SBT Trading Committee[119] of a legal width market;[120]
- The System receives a market or limit order (independent of the RFQ responses) on the opposite side that would match the original limit order, and a legal width market exists;[121]
- A certain prescribed percentage of the SBT market makers that currently are receiving RFQs (the percentage to be set by the appropriate SBT Trading Committee[122]) respond to the RFQ, or when the RFQ period expires and there is at least one quote response.[123]

If a limit order for a certain series were queued, subsequent limit orders for the same series and side would be queued behind the first order to ensure that they were processed in time sequence.[124] Subsequent market orders for the same series and side also would be queued.[125] If a legal width market remained upon completion of the limit order processing, the market order would be executed against orders resting in the SBT book.[126] If a legal width market did not exist, market order processing would begin in accordance with market order processing rules, discussed above.[127]

3. Contingency Orders

CBOE*direct* currently can handle all-or-none, fill-or-kill, immediate-or-cancel, stop, and stop limit orders. The System is not yet ready to process opening-only, minimum volume, and market-on-close orders,[128] although such orders are contemplated by the proposed CBOE*direct* rules, once the System is enabled to handle them.[129] Contingency orders (except for opening-only orders) would not participate in the opening trade or in the determination of the opening price.[130]

A contingency order (except for an immediate-or-cancel order or a stop limit order the stop price of which has been hit) would be placed last in priority order, regardless of when it was entered into the SBT System.[131] If customer priority were afforded to a particular option class, a public customer contingency order would have priority over a non-public-customer contingency order but would be behind all other orders.[132]

4. Spread Orders

Once the SBT System has been so enabled and the Commission has approved the necessary rules, SBT traders would have the ability to enter spread orders, the legs of which are options of the same underlying security.[133] However, spread orders may not be entered on the System at this time.

H. Facilitation and Solicitation of Orders by SBT Brokers

On the SBT System, an SBT broker would not be permitted to execute as principal an order that it represents as agent unless the agency order were first exposed on the System for at least 30 seconds, or the broker utilizes the applicable crossing procedure described below.[134] In addition, an SBT broker would be required to expose on the System an order that it represented as agent for at least 30 seconds before such order could be executed in whole or in part by orders solicited from members or non-member broker-dealers to transact with such order.[135] Described below are an interim crossing procedure and a permanent crossing procedure, which would replace the interim procedure at some time in the future.[136]

[112] *See* CBOE rule 43.7(a)(3)(B)(ii)(aa).

[113] *See* CBOE rule 43.7(a)(3)(B)(ii)(bb).

[114] *See* CBOE rule 43.7(d).

[115] *See* CBOE rule 43.8.

[116] *See id.*

[117] *See* CBOE rule 43.8A(a).

[118] *See* CBOE rule 43.8A(b). The SBT trader that submitted the limit order could override the RFQ and enter the limit order into the SBT book. *See id.*

[119] CBOE has represented that it would announce the percentage set by the committee in an information circular. December 5 conversation.

[120] *See* CBOE rule 43.8A(d)(1). The original limit order then would trade with the best priced quote or order on the SBT book. *See id.*

[121] *See* CBOE rule 43.8A(d)(2). The original limit order then would trade with the incoming market or limit order. *See id.*

[122] CBOE has represented that it would announce the prescribed percentage that would trigger this provision in an information circular. December 5 conversation.

[123] *See* CBOE rule 43.8A(d)(3). The original order then would trade with the best priced quote or order on the SBT book. *See id.*

[124] *See* CBOE rule 43.8A(e).

[125] *See id.*

[126] *See id.*

[127] *See id.*

[128] *See* Amendment No. 4.

[129] *See* CBOE rule 43.9.

[130] *See* CBOE rule 42.3(a).

[131] *See* CBOE rules 43.1(c) and 43.9.

[132] *See* CBOE rule 43.1(c).

[133] *See* CBOE rule 43.6(a).

[134] *See* CBOE rule 43.12(a).

[135] *See* CBOE rule 43.12(b).

[136] *See* CBOE rules 43.12A and 43.12B. CBOE rule 43.12C(a) provides that it would be a violation of

1. Interim Crossing Procedure

Under CBOE*direct*'s interim crossing procedure, an SBT broker that wishes to cross two original orders of at least 50 contracts or to facilitate an original order of at least 50 contracts must first send an RFQ with the size of the orders to be crossed.[137] The RFQ response period will be established by the SBT Trading Committee and will not be less than ten seconds.[138]

Within a time period after the RFQ response period has expired (such time period to be established by the SBT Trading Committee and not to exceed ten seconds [139], the SBT broker must expose one of the orders to the SBT book.[140] If the exposed order is not completely taken out by other SBT traders by the end of the exposure period, the SBT broker could enter the opposite order to cross the balance of the exposed order.[141]

2. Permanent Crossing Mechanism

In the future, CBOE*direct* will provide for a participation right for SBT brokers who wish to cross orders. As with the interim procedure, an SBT broker first would have to submit an RFQ for a size equal to the quantity to be crossed.[142] The SBT market makers receiving the RFQ would have a response period for a length of time (such time period to be established by the SBT Trading Committee, but no less than ten seconds [143] to enter orders or quotes that matched or improved upon the existing quotations on the System.[144] Within a time period after the RFQ response period expires (such time period to be established by the SBT Trading Committee and which may be no longer than 20 seconds [145]), the SBT broker would enter the terms of the proposed cross transaction.[146] The required terms would include the terms of the original order and the proposed facilitation order (or two original orders), a proposed crossing price, the quantity of the original order that the SBT broker would be willing to facilitate (in the case of a facilitation cross), and a designation of which order (in the case of a cross of two customer orders) is to be exposed to the market after the SBT broker received the guaranteed crossing percentage.[147] The customer order would be the exposed order in a facilitation cross.[148]

At the time the cross transaction is entered or the System:

- A legal width market would have to exist for the particular series to be crossed; and
- The proposed cross price would have to be between the best bid and offer displayed by the System.[149]

After accepting the cross transaction, the System would immediately cross 40% of the two orders. The System would expose in the SBT book the contracts remaining in the designated order for a period of ten seconds. The order's price and the remaining quantity would be disclosed but there would be no indication that the order was part of an impending cross. The System would place the opposite order on hold as a shadow order that would not be visible except to the submitter.[150] As long as the exposed order is the highest priority order at the best price, other SBT traders could trade against it during the ten-second exposure period.[151]

If, at the end of the ten-second exposure period the order has not yet been fully traded, and the exposed order is at the best price and has the highest priority, the System would execute the remainder of the order against the shadow order.[152] If, however, the exposed order is not the highest priority order at the market, the System automatically would cancel the remainder of the exposed order and the shadow order and send the SBT broker a message that the crossing transaction is completed. If the exposed order has a quantity remaining after the crossing transaction is completed and is the highest priority order at the market, it would remain in the SBT book.

3. Interpretation Relating to Crossing Procedure

The availability of the crossing mechanism would not alter a member's best execution duty to obtain the best price for its customer. Moreover, CBOE proposes to make it explicit in its rules that it would be a violation of an Exchange member's duty of best execution to its customer if it were to cancel or withhold a customer order to avoid execution of the order a better price.[153] Accordingly, if a member were to cancel or withhold a customer order when there was a superior price available on the System, and subsequently enter the order at an inferior price after the better price were no longer available without attempting to obtain that better price for its customer, there would be a presumption that the member did so to avoid execution of the customer order in whole or in part at the better price.[154]

I. Additional System Functionality

1. Entry and Maintenance of Orders and Quotes

All SBT traders, including SBT market makers, may enter orders into the System for any option class. However, only SBT market makers may enter quotes. An SBT market maker may have only a single quote for any particular option series but may enter multiple orders in the same series, regardless of whether it has a quote in that series displayed on the System. However, the SBT System would distinguish between an SBT market maker's quotes and orders and credit only the quotes towards the market maker's quoting obligations.[155]

An SBT market maker may enter a quote in one of two ways: manually or through an autoquote facility.[156] Unlike in the open-outcry system, the Exchange will not provide an autoquote facility to SBT market makers. However, SBT market makers may use their proprietary autoquote systems to submit quotes through the API.

CBOE rules 43.12, 43.12A, and 43.12B for an SBT broker to be a party to any arrangement designed to circumvent CBOE rule 43.12A or rule 43.12B by providing an opportunity for a customer, member, or non-member broker-dealer to execute against agency orders handled by the SBT broker immediately upon their entry into the System.

[137] *See* CBOE rule 43.12B(a).

[138] *See id.* CBOE has represented that it would announce the length of the response period set by the committee in an information circular. December 5 conversation.

[139] CBOE has represented that it would announce the length of the exposure period set by the committee in an information circular. December 5 conversation.

[140] *See* proposed CBOE rule 43.12B(b).

[141] *See* CBOE rule 43.12B(c).

[142] *See* CBOE rule 43.12A(a)(1).

[143] CBOE has represented that it would issue an information circular to publicize the time period established by the appropriate SBT Trading Committee. June 21 conversation.

[144] *See* CBOE rule 43.12A(a)(2).

[145] CBOE has represented that it would issue an information circular to publicize the time period established by the appropriate SBT Trading Committee. June 21 conversation.

[146] *See* CBOE rule 43.12A(a)(3).

[147] *See id.*

[148] *See id.*

[149] *See* CBOE rule 43.12A(a)(4). An SBT DPM or LMM would not be entitled to receive its participation right because a crossing transaction would occur at a price between the best bid and offer previously established. *See* CBOE rule 44.15(b).

[150] *See* CBOE rule 43.12A(a)(5).

[151] *See* CBOE rule 43.12A(a)(6).

[152] *See* CBOE rule 43.12A(a)(7).

[153] *See* CBOE rule 43.12A, Interpretation .01.

[154] *See id.*

[155] However, an SBT market maker would receive credit for an RFQ response only by submitting a quote and not two unrelated orders. Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Nancy Sanow and Michael Gaw, Division of Market Regulation, Commission, on September 30, 2002.

[156] *See* notice, *supra* note 4, 67 FR at 31039.

Depending on how a quote or order is modified, the quote or order could change priority position as follows: [157]

- If the price is changed, the changed side would lose priority position and would be placed behind all orders of the same type at the same price.
- If quantity of one side is changed, the unchanged side would retain its priority position.
- If the quantity of one side is decreased, that side would retain its priority position.
- If the quantity of one side is increased, that side would lose its priority position and would be placed behind all orders of the same type at the same price.

2. Time in Force of Orders/Quotes

The appropriate SBT Trading Committee would have the authority to determine which order types may be accepted at the various product states and session states.[158] Once the System is so enabled, customers would be able to specify that their day orders or good-'til-canceled orders are to be transferred between one CBOE trading session and the next, and they could determine to have their orders represented only during ETH sessions, only during RTH sessions, or carry over from one session to the next.[159]

3. Automatic Quote Regeneration

CBOE*direct* eventually will allow an SBT market maker to regenerate its quote where the bid or offer to be regenerated is a defined number of ticks worse than the bid or offer that had been hit.[160] The market maker would pre-set the System with the number of ticks worse by which its quote would regenerate.[161]

If an SBT market maker has the System regenerate its quote and the regenerated quote could immediately execute against the same incoming order that traded against the original quote, that portion of the regenerated quote equal to the original size executed against the market maker's original bid or offer would take priority over all other interest at the regenerated price, with respect to the balance of the incoming order, except in one circumstance. That circumstance would be if public customer priority was applicable to that option class and there were a public customer order at the same price as the regenerated bid or offer. The portion of a regenerated quote that is not executed would be placed in a priority position consistent with the time that the quote was regenerated.[162]

In Amendment No. 4, CBOE provided the following example to demonstrate the operation of the quote regeneration function:

Assume that price-time priority is in effect, with the public customer priority overlaid. The System receives a market order to sell 50 contracts ("Incoming Order"). The best bid is MM A's $3 bid for 20 contracts. The Incoming Order exhausts the $3 bid. The next best bid is $2.90 for 100 contracts consisting of MM B for 70 contracts, Customer A for 5 contracts, and MM A's regenerated quote for 25 contracts (its pre-determined regeneration size). The remaining 30 contracts of the Incoming Order would be filled as follows: 5 to the Customer, 20 to MM A, and 5 to MM B. After the Incoming Order is filled, the best bid would be 2.90 for 70 contracts with the following priority: MM B for 65 contracts and MM A for 5 contracts.

4. Quote Risk Monitor Function

CBOE indicated that SBT market makers are exposed to certain risks not present in an open-outcry trading environment: an SBT market maker could have a large number of its quotes hit by a set of incoming orders within a few seconds. Thus, the SBT market maker could find itself taking on a large position before it had an opportunity to assess this position and possibly change its quotes.[163] CBOE*direct*'s quote risk monitor feature is intended to permit an SBT market maker to manage its risk by automatically deleting the market maker's quotes in a class when the System determines that trades against the market maker's quotes have reached a defined number of contracts within a defined period of time. An SBT market maker may configure the System to set these limits with respect to its own quotes. In determining whether to delete quotes pursuant to this feature, the System would consider only trades against the SBT market maker's resting quotes, not trades that the SBT market maker itself initiates by hitting a bid or taking an offer.[164]

5. Managing Message Traffic

The Exchange may set limits on the quote traffic that is sent to the SBT System to prevent the System from becoming overloaded. However, CBOE has noted that, to the extent that the Exchange allows for varying quote traffic limits by SBT traders, such limits shall be objectively determined and submitted to the Commission for approval pursuant to section 19(b) of the Exchange Act.[165]

In addition, the Exchange may limit the number of SBT market makers that may access the SBT System through an API (or the number of messages sent by market makers accessing the System through an API) to protect the integrity of the System.[166] Furthermore, the Exchange may impose restrictions on the use of a computer connected through an API if it believed that such restrictions were necessary to ensure the proper performance of the System.[167] CBOE has represented that these limitations would be solely for the purpose of protecting the integrity of the System and would not be used in a discriminatory or arbitrary fashion.[168]

CBOE has represented that it does not intend to allocate bandwidth to each SBT trader, and that the System would not programmatically limit the number of messages that an SBT trader may send.[169] To minimize the potential of a particular SBT trader to burden the System unnecessarily, CBOE has stated that it wishes to be able to: (1) specify the number of quotes over a certain time period that may be sent free by an SBT trader, or (2) impose a fee per message for sending a number that is clearly above the free number and for producing a ratio of quotes to trades over a certain time period that is higher than what would be considered a reasonable ratio.[170]

J. Intermarket Price Protection

Non-broker-dealer market and marketable limit orders would not be automatically executed on CBOE*direct* at prices inferior to the best bid or offer on another national securities exchange, as those best prices are identified in the System.[171] If there is a better quote on

[157] *See* CBOE rule 43.1(f).

[158] *See* CBOE rule 43.3(a). At the discretion of the appropriate SBT Trading Committee, and once the System is so enabled, any of the following order types may be accommodated on CBOE*direct:* market orders, limit orders, cancel orders, cancel replace orders, day orders, good-for-session orders, good-'til-canceled orders, and contingency orders. *See* CBOE rule 43.2(a). *See also supra* notes 128 to 129 and accompanying text. CBOE has represented that it would issue an information circular regarding the types of orders that will be accommodated on CBOE*direct.* February 20 conversation.

[159] *See* CBOE rule 43.3(b).

[160] *See* CBOE rule 44.5(b). The Exchange would determine the number of ticks below the original price at which the quote may be regenerated and publicize this determination in an information circular. December 5 conversation.

[161] *See id.*

[162] *See* CBOE rule 43.1(e).

[163] *See* Notice, *supra* note 4, 67 FR at 31040.

[164] *See* CBOE rule 44.5(c).

[165] *See* CBOE rule 44.5(d).

[166] *See* CBOE rule 44.6.

[167] *See* id.

[168] *See* notice, *supra* note 4, 67 FR at 31040–41.

[169] *See* notice, *supra* note 4, 67 FR at 31040.

[170] *See id.* Any proposal to charge such a fee would have filed with the Commission pursuant to section 19(b) of the Act, 15 U.S.C. 78s(b). *See infra* note to and accompanying text.

[171] *See* CBOE rules 43.7 and 43.8. The System would have access to the OPRA quote stream and be programmed not to automatically execute a trade in an options series if the System identifies a better

another exchange, the SBT DPM or LMM would be required to handle the order manually.[172] CBOE represented its view that the SBT DPM or SBT LMM handling public customer orders under these circumstances would be acting as agent for such orders.[173] Accordingly, the SBT DPM or LMM would be required to accord priority to such public customer order over its own orders as principal, unless the customer who placed the order has consented to not being accorded such priority.[174] Finally, to comply with its obligations under the Options Linkage Plan, CBOE rules 6.80 through 6.85 [175] would apply to trading on the SBT System.

K. Trade Reporting and Data Dissemination

1. Executed Orders

The System would send executed orders to the Exchange's Trade Match System as matched trades. The System would send fill reports for executed orders to the SBT workstations for display to SBT traders.[176]

2. Internal Dissemination of Quote and Best Bid/Offer

Any subscriber to CBOE*direct* would be able to view the System's best bid and offer for any options series traded on the System.[177] The System would send quote/order information—*i.e.*, series, price, and size—to the SBT workstations that are trading a given class.

3. Dissemination of Quotes to OPRA

The series and price of an option would be disseminated for each quote; the size of the quote also would be disseminated. Every change to CBOE*direct*'s best bid or ask would generate a quote report to OPRA and/or some other network that has been approved by the Commission.[178] Changes in best quote and size due to all-or-none or fill-or-kill contingency orders would not result in a message to OPRA to update the CBOE*direct* quote.[179]

4. Last Sale Information

CBOE*direct* would internally disseminate last sale information—including series, price, and size—to subscribers that have indicated interest in a given class.[180] All SBT market makers assigned to a given class would be provided this information, but other individuals and firms could subscribe to this information as well.[181] CBOE*direct* also would disseminate last sale information externally to OPRA and/or another distribution network to the extent permitted by agreement or by rule.

5. Booked Order Dissemination

When an SBT trader requests information for an option class, the System would provide the information that presents the SBT book's best bids and asks and the aggregate size for each series of the class requested.[182] CBOE could add or delete categories of disseminated information as it deemed appropriate.[183] Although CBOE believes that such information generally would be available, it may determine not to provide such information if the System were nearing its message capacity and degradation of the System could result. CBOE may charge fees for such information; different fees may be charged to different categories of SBT traders.[184]

II. Amendment No. 4

The foregoing discussion incorporated revisions proposed in Amendment No. 4 to the proposed rule change. Specifically, in Amendment No. 4, CBOE:

- Revised the definitions of ''fill-or-kill'' and ''immediate-or-cancel'' orders to clarify that such orders must be filled immediately upon receipt or canceled;
- Clarified the definitions of ''RFQ'' and ''Special RFQ'' and explained why RFQs would be sent only to SBT market makers;
- Added a provision that SBT DPMs and LMMs will not receive any trade participation right until public customers' orders at the best price have been executed, and clarified that an SBT DPM's or LMM's trade participation right will apply only to the portion of an order remaining after all higher priorities are satisfied;
- Substantially revised the trade nullification procedures to include specific objective criteria as to when a trade may be broken;
- Specified that non-broker dealer market orders and marketable limit orders will not be automatically executed at prices inferior to the best bid or offer on another exchange, as those best prices are identified in the System;
- Added provisions requiring SBT brokers to expose orders that they represent as agent for at least 30 seconds or, if appropriate, to use the crossing mechanism;
- Revised the crossing procedures to require orders to be for at least 50 contracts to be eligible for the crossing mechanism, to establish minimum time periods for which such proposed crosses must be exposed, and to specify that cross transactions may be effected only in increments equal to or greater than the Exchange's minimum quoting increments;
- Added an interpretation regarding a member's duty of best execution, prohibited circumvention of the rules on crossing orders, and represented that CBOE will surveil for violations of the crossing rules;
- Added a rule relating to responsible brokers' and dealers' firm quotation obligations in CBOE*direct* and eliminated the application of CBOE rule 8.51, the firm quote requirements of trading crowds on the floor, to SBT market makers;
- Revised the obligations of SBT standard market makers and SBT DPMs and LMMs, including adding requirements relating to RFQ response rates;
- Eliminated the special rules relating to the processing of spread orders;
- Deleted a rule relating to the Exchange's position that information sent over the SBT System is the Exchange's proprietary information;
- Represented that CBOE rule 4.18 requires SBT market makers to maintain information barriers with any affiliates that may act as a specialist or market

price for that series in another market that participates in the OPRA plan. Telephone conversation between Angelo Evangelou, CBOE, and Michael Gaw, Division of Market Regulation, Commission, on August 16, 2002. Current CBOE rules would not permit another exchange's quotes to be excluded from the best prices identified by the System. Telephone conversation between Angelo Evangelou, Legal Division, CBOE, and Elizabeth King, Division of Market Regulation, Commission, on February 21, 2003.

[172] *See* CBOE rules 44.4, Interpretation .01(a)(6) and 44.14(b)(6).

[173] *See* Amendment No. 4. The Commission notes that the Exchange committed to file in the near future a proposed rule change under section 19(b) of the Act to expressly state that the SBT DPM and LMM act as agent when handling customer orders manually.

[174] *See id.*

[175] *See* Securities Exchange Act Release No. 47294 (January 31, 2003), 68 FR 6527 (February 7, 2003) (approving SR-CBOE–2002–61).

[176] *See* notice, *supra* note 4, 67 FR at 31026.

[177] *See* CBOE rule 46.1(a).

[178] The Commission notes that the OPRA plan does not presently permit an options exchange to disseminate quotes to another network without also disseminating such quotes to OPRA.

[179] *See* notice, *supra* note 4, 67 FR at 31041.

[180] *See* CBOE rule 46.1(b).

[181] *See id.*

[182] *See* CBOE rule 46.1(c).

[183] *See id.* For example, CBOE could determine to provide book depth to a certain number of levels, but later determine to reduce the number of levels provided as circumstances warranted. Telephone conversation between Angelo Evangelou and Andy Lowenthal, CBOE, and Nancy Sanow and Michael Gaw, Division of Market Regulation, Commission, on November 7, 2002.

[184] Any proposal to charge such a fee would have to filed with the Commission pursuant to section 19(b) of the Act, 15 U.S.C. 78s(b).

maker in any security underlying the options for this the CBOE member acts as an SBT market maker;

- Represented that CBOE believes that, when an SBT DPM or LMM is required to handle customer orders under rules 44.14(b)(6) or 44.4.01(a)(6), the DPM or LMM is acting as an agent with respect to those public customer orders;
- Explained the priority accorded to regenerated quotes;
- Clarified that trading officials will use the same criteria to halt trading on the SBT System as is used for CBOE's trading floor;
- Revised Appendix A, which sets forth the existing CBOE rules that also will apply to CBOE*direct,* by including, among others, CBOE rule 3.22, Temporary Access; CBOE rule 4.19, Prohibition Against Harassment, and the rules in section E to chapter VI, Intermarket Linkage; and
- Made other minor, technical changes to the proposed CBOE*direct* rules and to certain existing CBOE rules to accommodate the establishment of the SBT System.

III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.[185] In particular, the Commission finds that the proposal is consistent with section 6(b)(5) of the Act,[186] which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade; to facilitate transactions in securities; to remove impediments to and perfect the mechanisms of a free and open market and a national market system; and, in general, to protect investors and the public interest. Although the Commission did not receive any comments on the proposed rule change, it believes that several aspects of the proposed rules governing CBOE*direct* merit greater discussion.

A. RFQs and Market Maker Quoting Obligations

For each options series traded on CBOE's floor today, a single quotation is disseminated that reflects the aggregate trading interest of one or more customers and/or crowd participants, including the DPM and market makers. DPMs generally are required to make continuous markets in the option classes for which they serve as DPM. By contrast, the CBOE*direct* rules do not require SBT DPMs and LMMs to make continuous markets.[187] Therefore, it is possible that, at a particular point in time, CBOE will not have a disseminated market for a particular option. Instead, the current market for a particular product may be available only through the RFQ process. The Commission believes that CBOE*direct*'s reliance on RFQs as a means of price discovery when the orders and quotes on the SBT book are not sufficient to satisfy trading demand is consistent with the Act.

CBOE's rules require SBT market makers to fulfill certain requirements as market makers. Specifically, SBT market makers, among other things, are required to have at least 75% of their total contract volume on the SBT System in options classes to which they are appointed. In addition, SBT standard market makers are required to respond to at least 75% of the RFQs that they receive, and SBT DPMs and LMMs are required to respond to at least 98% of the RFQs that they receive. Moreover, RFQ responses must meet certain parameters for them to count toward the SBT market maker's quote response obligations.[188]

Market makers receive certain benefits for carrying out their duties. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T if the credit is to be used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.[189] The Commission believes that an SBT market maker must have an affirmative obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis to justify this favorable treatment. In this regard, the Commission believes that CBOE's rules impose such affirmative obligations on SBT market makers.

B. Trade Participation Right for SBT DPMs and LMMs

The CBOE*direct* rules allow the Exchange to award SBT DPMs and LMMs a participation right of up to 40% of the portion of an order remaining after orders and quotes of other market participants with higher priority have been satisfied, provided that the DPM or LMM has a quote or order at the best price. The Commission continues to believe that it is consistent with the Act to guarantee a DPM or LMM the right to trade ahead of other market makers, even when the DPM or LMM has not otherwise established priority. These guarantees are intended to provide an incentive for market makers to assume the extra responsibilities assigned to DPMs and LMMs, such as the obligation to provide opening quotes in assigned classes, to respond to a greater percentage of RFQs than SBT standard market makers, and to handle public customer orders when there is a better price on another market.

The Commission recognizes that a large guaranteed participation right will erode the incentive of other market makers to make competitive markets. Thus, the Commission must weigh whether a proposed participation right adequately balances the aim of rewarding the specialist or primary market maker with the aim of leaving a sizeable enough portion of the incoming order for the other market makers quoting at the same price.[190] The Commission has previously taken the position that a trade participation right that does not exceed 40%, including any guaranteed percentage of the trade to be accorded to any other trade participant, is not inconsistent with the Act.[191]

Finally, CBOE proposed that public customer orders at the best price be filled before an SBT DPM or LMM receives its trade participation right.[192] Although, as discussed below, the Commission does not believe that customers who may electronically generate orders must be accorded priority over market makers who are not acting as agent with respect to these customers, the Commission does believe it is appropriate for customer orders to have priority over a specialist's trade participation right.

C. Priority and Trade Allocation Methodology

The Commission considers each of the priority and trade allocation rules

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[185] In approving the proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

[186] 15 U.S.C. 78f(b)(5).

[187] *See* CBOE rules 44.4, Interpretation .01(a)(4) and 44.14(a)(4). The appropriate Market Performance Committee may, but is not required to, require an SBT DPM or LMM to provide continuous quotes in some or all of its appointed option series. *See id.*

[188] *See supra* notes 27 to 29 and accompanying text.

[189] *See* 12 CFR 221.5(c)(6).

[190] *See* Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778, 48787–90 (August 9, 2000) (''Phlx 80/20 Proposal'') (Commission requested comment on whether the proposal by the Philadelphia Stock Exchange to establish an 80% specialist guarantee would be consistent with the Act).

[191] *See, e.g.*, Securities Exchange Act Release No. 45936 (May 15, 2002), 67 FR 36279, 26280 (May 23, 2002); Securities Exchange Act Release No. 42835 (May 26, 2000), 65 FR 35683, 35685–66 (June 5, 2000); Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11398 (March 2, 2000); Phlx 80/20 Proposal, 67 FR at 48787–88.

[192] *See* CBOE rule 43.1(b)(3)(E).

(*i.e.*, price-time priority or pro rata priority) proposed for CBOE*direct* to be consistent with the Act. In addition, the Commission believes that each of the priority overlays (*i.e.*, public customer, marker turner, and SBT DPM and LMM trade participation right) is consistent with the Act. In making its determination that these priority rules are consistent with the Act, the Commission considered it critical that an SBT DPM or LMM cannot receive its trade participation right before any public customer orders at the same price are executed in full.

The SBT Trading Committee has the ability, but is not required, to grant customers the highest priority at a particular price level. Currently, in the rules governing trades on CBOE's floor, customer orders displayed on the limit order book are given priority over broker-dealer orders and market maker quotes.[193] This is essential under CBOE's rules because the DPM is the agent for orders resting in the limit order book and, therefore, consistent with general agency law principles, CBOE's rules accord priority to those resting limit orders. In contrast, an SBT market maker is not required to act as agent with respect to a limit order entered into CBOE *direct*.[194] Moreover, the CBOE's rules do not prohibit customers from electronically generating orders for entry into the CBOE*direct* book as they do for orders eligible for the Exchange's Retail Automatic Execution System.[195] The Commission, therefore, believes that it is consistent with the Act for the CBOE*direct* rules not to provide in all approaches that public customer orders have priority over market maker quotes and orders.

D. Obligations Under the Linkage Plan

SBT DPMs and LMMs will be required to handle public customer orders when there is a better quote on another exchange. In addition, to comply with its obligations under the Options Linkage Plan,[196] CBOE rules 6.80 through 6.85 will apply to the SBT System.[197] It appears that these provisions satisfy CBOE's obligations under the Options Linkage Plan.

E. Internalization and Crossing Transactions

As the Commission has noted,[198] with multiple trading of options, individual options markets are under significant pressure to attract or retain business. One approach to increasing business on an exchange is to allow members a preference in trading with customer orders that they bring to the exchange. These preferences can have the effect of reducing intramarket price competition when a right to receive a portion of the trade is guaranteed to a member based on its status as an order provider rather than to reward market makers for providing the best quotes. If exchange rules do not provide a fair opportunity for market participants to compete for orders based on price, there is a disincentive to provide competitive quotes on the exchange and thus price competition may suffer. Eventually, if execution guarantees to particular exchange members become too great, the number of competitive market makers could diminish, thereby impeding intramarket price competition. As a result, the prices available on a market could deteriorate—ultimately harming investors.

The CBOE*direct* rules include an interim crossing procedure, which does not provide for any guarantee to the SBT broker facilitating the order, and a regular crossing procedure, which will provide for a guarantee to the SBT broker facilitating the order. The eligible order size for using either crossing procedure is 50 contracts. The crossing procedures require the SBT broker to initiate the process by submitting an RFQ with size to SBT market makers who are registered in that class. Both the interim and regular crossing procedures set forth minimum time periods that these SBT market makers are given to respond to the RFQ. The RFQ will be anonymous; no SBT trader will be able to learn the identity of the SBT broker who is crossing the order. The Commission believes that this anonymity is an important difference between CBOE*direct* and floor-based auction markets. The automated, non-personal nature of the SBT System provides no opportunity for agreements between the facilitating firm and the trading crowd whereby, for example, the trading crowd agrees not to break up a firm's proposed facilitations in exchange for the firm's agreement to bring order flow to the exchange.

In the regular crossing procedure, an SBT broker seeking to facilitate an order is guaranteed a participation right if, at the end of the RFQ response period, the broker improves the price that the customer would receive by entering a proposed cross at a price between the best bid and offer. The participation right of the SBT broker seeking to internalize the order when using the regular crossing procedure would be set at 40%.[199] The remaining 60% of the order would be entered on the SBT book as a limit order at the proposed crossing price. All participants in the SBT System would be able to trade with this limit order at the proposed price or at an improved price. The Commission believes that the time periods required by the regular CBOE*direct* crossing procedure would afford SBT market makers an adequate amount of time in which to respond to the RFQ during the initial response period and for all participants in CBOE*direct* to compete for 60% of the order during the exposure period that followed. In the interim crossing procedure, the exposure period would give CBOE*direct* participants an opportunity to compete for 100% of the order before the SBT broker could participate.

In addition, with respect to orders that do not qualify for, or for which the SBT broker has chosen not to use, the interim or regular crossing procedures, an SBT broker would have to expose such orders on the System for at least 30 seconds before executing any part of the order as principal. Similarly, orders

[193] *See* CBOE rule 6.45(a)(i) and (b). *See also* CBOE rule 6.74(d)(ii) (giving public customer orders represented in the trading crowd priority over other participants in the context of crossing transactions).

[194] The SBT DPM or LMM, however, would act as agent when handling an order when there is a better price on another market.

[195] *See* CBOE rule 6.8A(a). CBOE has confirmed in its cover letter to Amendment No. 4 that CBOE rule 6.8A does not apply to CBOE*direct.*

[196] Because of concerns about the increasing likelihood of intermarket trade-throughs of customer orders in the options markets following the widespread expansion of multiple trading, the Commission in October 1999 ordered the options exchanges to work together to file a national market system plan for linking the options markets (''Options Linkage Plan''). *See* Securities Exchange Act Release No. 42029 (October 19, 1999), 64 FR 57674 (October 26, 1999). The Commission approved an initial Options Linkage Plan in July 2000. *See* Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000). The Commission subsequently approved amendments to that plan in May 2002 that set forth phase one of the plan's implementation, providing for automatic execution of orders routed to from one options exchange to another, and phase two, to implement all other linkage functionality. *See* Securities Exchange Act Release No. 46001 (May 30, 2002), 67 FR 38687 (June 5, 2002). Implementation of phase one began on January 31, 2003, and implementation of phase two must occur no later than April 30, 2003. *See id.,* 67 FR at 38688.

[197] *See* Securities Exchange Act Release No. 47294 (January 31, 2003), 68 FR 6527 (February 7, 2003) (adopting rules for CBOE relating to the Options Linkage Plan).

[198] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11395 (March 2, 2000) (Order approving registration of International Securities Exchange LLC as a national securities exchange) (''ISE Order'').

[199] *See* CBOE Rule 43.12(a)(5). The Commission notes that in this context the SBT DPM or LMM would not be entitled to a trade participation right because the crossing transaction must occur at an improved price, which by its terms must be a better price than the previously established bid or offer of the SBT DPM or LMM.

must be exposed on the System for at least 30 seconds before they may be executed by orders solicited from members and non-member broker-dealers. These rules ensure that the crossing procedures and the limitations on facilitation described above are not circumvented.

The CBOE*direct* rules also would prevent an SBT broker from being party to any arrangement designed to circumvent the proposed crossing rules by providing an opportunity for another party to execute against an agency order immediately after the broker had entered the order in the SBT System.[200] The Commission believes that the prohibition on such arrangements is important, because an SBT broker and a third party could otherwise use CBOE*direct* to execute their orders with each other, without exposing these orders to other trading interest. The Commission believes that this prohibition should prove helpful in curbing a firm's ability to internalize order flow.[201]

Finally, the proposed rules also include an interpretation stating that a violation of a member's duty of best execution would be presumed if the member were to cancel or withhold a facilitation order to avoid execution of the order at a better price.[202] Use of the crossing mechanism would not modify a member's best execution duty to its customer. The Commission believes that this interpretation is important to ensure that SBT brokers who propose to facilitate orders as principal fulfill their duty of best execution. In the Commission's view, withholding or withdrawing an order to be facilitated—that could benefit from price improvement available from other market participants—simply to avoid executing the order at the superior price would be a violation of the broker's best execution duty.[203]

As a national securities exchange, CBOE is required to enforce its members' compliance with their best execution obligations. The Commission notes that when a SBT broker enters a facilitation transaction into the crossing mechanism and then cancels the remainder of the customer order after the 40% of the order is executed, this could indicate—depending on the circumstances—that the broker originally overstated the size of the customer order and, with the 40% execution, effectively internalized 100% of the customer order. This situation would not be consistent with the SBT system's crossing rules. CBOE has committed to surveil for instances when a SBT broker immediately cancels the crossing transaction once 40% of the order is executed. The Commission notes that if, after receiving the responses to an RFQ, the SBT broker elects not to enter the transaction into the crossing mechanism because he or she is unwilling to facilitate the customer order at the requisite price between the best bid and offer displayed by the System, depending on the circumstances, the SBT broker may have a best execution obligation to enter the customer order into the System to execute against the appropriate best response to the RFQ.

The Commission finds that the rules proposed by CBOE relating to crossing and internalization of orders on the SBT System are consistent with the Act. The Commission believes that these rules will promote intramarket price competition by providing SBT traders with a reasonable opportunity to compete for a significant percentage of the incoming order and, therefore, will protect investors and the public interest.

F. Simultaneous Trading of the Same Security on CBOEdirect and the Exchange Floor

CBOE has not proposed any rules that would govern order handling and order priority if the same option were traded simultaneously on CBOE*direct* and on CBOE's floor-based market. Accordingly, the Commission is not approving the use of CBOE*direct* to trade any security during a trading session in which such security is trading on CBOE's floor-based market.[204] The Commission believes that trading the same option classes on the floor and on the SBT System at the same time raises several issues under the Act that CBOE must address—by filing one or more proposed rule changes pursuant to section 19(b) of the Exchange Act[205]—before the Commission could approve concurrent trading of the same option classes.

G. Trade Nullification Procedures and the Firm Quote Rule

The rules governing CBOE*direct* provide for the ability of one or both parties to a transaction to nullify the trade. Both parties to the trade can agree to have a trade nullified and, in that case, the CBOE*direct* rules prescribe that certain procedures be followed for negotiated trade nullification.

The rules also provide for a procedure whereby an SBT trader may request two trading officials to nullify a trade. Specifically, a trade may be nullified by one party to the transaction if a documented request is made within five minutes or, in the case of a public customer order, within 15 minutes of execution, and one of the following conditions is satisfied: (1) There is a verifiable disruption or malfunction in Exchange systems that cause a quote/order to trade in excess of its disseminated size or that prevent an SBT trader from updating or canceling its quote/order; (2) the trade resulted from an erroneous print in the underlying security that resulted in a trade higher or lower than the average trade in the underlying security by a specified factor; (3) the trade resulted from an erroneous quote in the primary market for the underlying when certain other conditions are met; or (4) the execution price of the trade is higher or lower than the theoretical price for the series by a specified factor. A party to the trade that disagrees with the trade nullification can appeal the determination under Chapter XIX of the Exchange's rules.

The Commission considers that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price or other terms of the executed trade are such that they are ''clearly erroneous,'' suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, abrogating a trade should occur under specific and objective circumstances only. The trade nullification rule for CBOE*direct* contains specific and objective criteria with respect to the circumstances when a trade can be nullified, which helps to ensure that the rule would be applied in a fair and non-discriminatory manner. In addition, the conditions under which a trade can be nullified indicate that the error would be ''clearly erroneous,'' *i.e.*, the terms of the trade clearly were outside of the norm for other trades that were executed within a proximate time frame. In addition, the CBOE*direct* rule on trade nullification contains clear procedures on how the trade would be nullified and provides a time frame within which a request to nullify a trade must be made. Finally, the trade nullification rule specifies the procedures to be followed for an appeal by a party who disagrees with the result.

[200] *See* CBOE rule 43.12C(a).

[201] The Commission previously approved a similar provision as part of the ISE's rules. *See* ISE rule 400, Supplementary Material; ISE Order, 65 FR at 11400.

[202] *See* CBOE rule 43.12A, Interpretation .01.

[203] *See* ISE Order, 65 FR at 11398 (discussing a similar provision in the ISE rules).

[204] In Amendment No. 4, the Exchange eliminated the text of its proposed rule 43.10 regarding the trading of spread orders on CBOE*direct.*

[205] 15 U.S.C. 78s(b).

In light of the foregoing, the Commission believes that the trade nullification rule for CBOE*direct* is appropriate.

H. Integrated Market Making and Side-by-Side Market Making

Under the Commodity Futures Modernization Act of 2000,[206] futures contracts on single securities and narrow-based security indexes may now be traded under the joint jurisdiction of the Securities and Exchange Commission and the Commodity Futures Trading Commission. The Commission understands that SBT traders who may make markets in options on CBOE*direct* also may make markets in security futures that are based on the same underlying security or may have an affiliate that engages in such trading. In addition, SBT traders who effect transactions in a particular option may be affiliated with market makers or specialists who trade the underlying security (*i.e.,* ''integrated market making''). The Exchange has indicated that CBOE Rule 4.18, which governs the use of material, non-public information, would apply to members trading on CBOE*direct*. The Exchange represented that this rule would require a SBT market maker to maintain information barriers—that are reasonably designed to prevent the misuse of material, non-public information by such member—with any affiliates that may act as a specialist or market maker in any security underlying the options for which the CBOE member acts as a SBT market maker. The Commission believes that the requirement that there be an information barrier between the SBT market maker and its affiliates with respect to transactions in the option and the underlying security serve to reduce the opportunity for unfair trading advantages or misuse of material, non-public information.

I. Managing Message Traffic

CBOE has indicated that it may, in the future, be necessary to set limits on the message traffic on the SBT System to prevent it from becoming overloaded. For example, CBOE has stated that it may have to limit the number of SBT market makers that may access the SBT System through an API, or limit the number of messages sent by market makers accessing the System through an API, to protect the integrity of the System.[207] Furthermore, CBOE has indicated that it may have to impose restrictions on the use of a computer connected through an API if it believed that such restrictions were necessary to ensure the proper performance of the System.[208] In addition, CBOE has stated that it wishes to be able to: (1) Specify the number of quotes over a certain time period that may be sent free by an SBT trader, or (2) impose a fee per message for sending a number that is clearly above the free number and for producing a ratio of quotes to trades over a certain time period that is higher than what would be considered a reasonable ratio.[209] Finally, CBOE has indicated that it intends to charge fees for RFQs that exceed a certain ratio of requests-to-trades.[210]

Trading options in an electronic environment presents greater capacity burdens than does the electronic trading of equity securities. For every equity security, there potentially exists dozens of overlying options, each series having a different expiration date or strike price. The continuous quoting of options, therefore, generates far more message traffic than the continuous quoting of equity securities. The Commission acknowledges that an electronic options exchange has a legitimate interest in ensuring that the amount of message traffic passing through the facilities of that exchange does not become so great as to compromise system performance. However, the Commission expects CBOE to file with the Commission, in accordance with the procedural requirements of section 19(b) of the Act[211] and the substantive requirements of section 6(b) of the Act,[212] any proposal to throttle message traffic. The Commission notes in particular that any such proposal by the Exchange must not permit unfair discrimination between CBOE*direct* participants.[213] Section 6(b) also requires that any dues, fees, or other charges imposed by a national securities exchange must be fair and reasonable and allocated equitably.[214]

J. Accelerated Approval

Pursuant to section 19(b)(2) of the Act,[215] the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving the proposal, as amended by Amendment No. 4, prior to the 30th day after publishing notice of the amended proposal in the **Federal Register**. Many of the revisions made to the proposal in CBOE's Amendment No. 4 are modeled on existing CBOE floor rules or the rules of the ISE. The Commission previously approved these CBOE rules and ISE rules and therefore believes that accelerating such rules for CBOE*direct* is appropriate because these revisions do not raise new regulatory issues. Other revisions, although not based on existing ISE or CBOE rules, were not material to the overall proposal. The Commission believes that no purpose would be served by delaying approval of the proposal until those additional revisions had been published for comment, particularly in light of the fact that no comments were received in response to the notice. Therefore, the Commission finds that good cause exists to accelerate approval of the amended proposal.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 4, including whether the amendment 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. 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 filings will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR–CBOE–00–55 and should be submitted by May 1, 2003.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[216] that the proposed rule change (SR–CBOE–00–55), as amended, is approved on an accelerated basis.

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[206] Pub. L. No. 106–554, Appendix E, 114 Stat. 2763.

[207] *See* CBOE rule 44.6.

[208] *See id.*

[209] *See* notice, *supra* note 4, 67 FR at 31040.

[210] *See* notice, *supra* note 4, 67 FR at 31039.

[211] 15 U.S.C. 78s(b).

[212] 15 U.S.C. 78f(b).

[213] *See* 15 U.S.C. 78f(b)(5).

[214] *See* 15 U.S.C. 78f(b)(4).

[215] 15 U.S.C. 78s(b)(2).

[216] 15 U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[217]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–8730 Filed 4–9–03; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47623; File No. SR–NASD–2003–65]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Extend the Pilot Period for the Regulatory Fee and the Trading Activity Fee

April 3, 2003.

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 March 31, 2003, the National Association of Securities Dealers, Inc. (''NASD'') 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 NASD. The NASD filed the proposal pursuant to section 19(b)(3)(A) of the Act,[3] and Rule 19b–4(f)(6) thereunder,[4] which renders the proposal effective upon filing with the Commission.[5] 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

The NASD proposes to extend the pilot period for the Trading Activity Fee (''TAF'') through April 15, 2003. The TAF (as originally proposed in SR–NASD–2002–98) is in effect, and is set to expire on April 1, 2003.[6] The NASD is requesting the Commission approve SR–NASD–2002–148, granting permanent approval of the TAF, before the expiration of the TAF pilot on April 15, 2003.[7] If the Commission does not approve SR–NASD–2002–148 before the expiration of the TAF pilot on April 15, 2003, the trading fee component of the member regulatory pricing structure will revert to Section 8 of Schedule A to the NASD By-Laws, as amended.

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 NASD included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The NASD 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

On July 24, 2002, the NASD filed SR–NASD–2002–98, which proposed a new member regulatory pricing structure, including the TAF, to replace the existing trading fee contained in section 8 of Schedule A to the NASD By-Laws.[8] SR–NASD–2002–98 is currently in effect. Assessments under the TAF were effective as of October 1, 2002, payable January 15, 2003.[9] On October 18, 2002, the NASD established a sunset provision whereby the TAF established by SR–NASD–2002–98 would cease to exist after December 31, 2002.[10] Upon expiration of SR–NASD–2002–98, the member regulatory pricing structure was to revert to Section 8 of Schedule A to the NASD By-Laws, as amended.

On December 24, 2002, the NASD extended the TAF pilot through March 1, 2003. On February 28, 2002, the NASD again extended the TAF pilot through April 1, 2003. With the instant proposed rule change, the NASD is extending the TAF pilot through April 15, 2003, to allow the Commission additional time to review issues presented by the proposal to make the TAF permanent (SR–NASD–2002–148). The NASD requests that the Commission approve SR–NASD–2002–148 before the expiration of the TAF pilot on April 15, 2003.

2. Statutory Basis

The NASD believes that the proposed rule change is consistent with the Act, including section 15A(b)(5),[11] which requires, among other things, that the NASD's rules provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system that the NASD operates or controls.

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

The NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments on this proposed rule change were neither solicited nor received. Written comments, however, have been solicited by publication in the **Federal Register** of SR–NASD–2002–98, SR–NASD–2002–147, SR–NASD–2002–148, SR–NASD–2002–182, and SR–NASD–2003–26.

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

Because the foregoing proposed rule change does not:

(i) Significantly affect the protection of investors or the public interest;

(ii) Impose any significant burden on competition; and

(iii) Become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to section 19(b)(3)(A) of the Act[12] and Rule 19b-4(f)(6) thereunder.[13]

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[217] 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] The Commission waived the five-day pre-filing notice requirement. *See* Rule 19b–4(f)(6)(iii). 17 CFR 240.19b–4(f)(6)(iii). The NASD also asked the Commission to waive the 30-day operative delay.

[6] *See* Securities Exchange Act Release No. 46416 (August 23, 2002), 67 FR 55901 (August 30, 2002) (SR–NASD–2002–98). *See also* Securities Exchange Act Release Nos. 47112 (December 31, 2002), 68 FR 824 (January 7, 2003) (SR–NASD–2002–182) and 47436 (March 4, 2003), 68 FR 11422 (March 10, 2003) (SR–NASD–2003–26).

[7] *See* Securities Exchange Act Release No. 46817 (November 12, 2002), 67 FR 69785 (November 19, 2002)(SR–NASD–2002–148).

[8] Securities Exchange Act Release No. 46416 (August 23, 2002), 67 FR 55901 (August 30, 2002) (SR–NASD–2002–98). *See also* Securities Exchange Act Release No. 46417 (August 23, 2002), 67 FR 55893 (August 30, 2002) (SR–NASD–2002–99). The NASD also published three *Notices to Members* describing the proposed changes and addressing interpretive questions posed by NASD members. *See Notices to Members 02–41* (July 2002), *02–63* (September 2002), and *02–75* (November 2002).

[9] Member firms were required to pay the TAF in accordance with the pilot program (for the first quarter starting October 1, 2002) by no later than January 15, 2003, and thereafter, on a monthly basis.

[10] At the same time, the NASD filed a new proposed rule change (SR–NASD–2002–148), substantially similar to SR–NASD–2002–98, but filed under section 19(b)(1) of the Act, to allow for additional comment.

[11] 15 U.S.C. 78o–3(b)(5).

[12] 15 U.S.C. 78s(b)(3)(A).

[13] 17 CFR 240.19b–4(f)(6).