

“Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to institute “Market at 4 p.m.” (“MCC”) Orders for Exchange Traded Funds (“ETFs”). On April 17, 2003 the Amex amended the proposal.³

The proposed rule change, as amended, was published for comment in the **Federal Register** on May 1, 2003.⁴ The Commission received no comments on the proposal.

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁵ and, in particular, the requirements of section 6 of the Act⁶ and the rules and regulations thereunder. The Commission finds that the proposed rule change is consistent with section 6(b)(5) of the Act⁷ because it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

Specifically, the Commission believes that the procedures proposed for executing MCC Orders are similar to those currently existing for “Market at the Close” (“MOC”) Orders for all Amex-listed stocks. The Commission also notes that the MOC Order procedures for Amex-listed stocks have been approved on a permanent basis since 1992.⁸ The Commission also

believes that the procedures for executing MCC Orders may potentially provide customers with additional flexibility in order execution by permitting transactions in ETFs near the close of the day at a price that is closely related to the closing price of the underlying components for those ETFs.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,⁹ that the proposed rule change (SR-Amex-2003-17) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47959; File No. SR-CBOE-2002-05]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments No. 1, 2, 3, and 4 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 5 and 6 Thereto by the Chicago Board Options Exchange, Incorporated Relating to the Introduction of the CBOE Hybrid System

May 30, 2003.

I. Introduction

On January 18, 2002, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission” or “SEC”), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to implement the CBOE Hybrid System. The CBOE filed Amendments No. 1, 2, 3, and 4 to the proposed rule change on April 2, 2002, May 17, 2002, January 16, 2003, and April 7, 2003, respectively.³ The proposed rule change and Amendments No. 1, 2, 3, and 4 were published for comment in the **Federal Register** on April 22, 2003.⁴ The Commission received two comment

procedures to execute MOC orders on every trading day).

¹ 15 U.S.C. 78s(b)(2).

² 17 CFR 200.30-3(a)(12).

³ 15 U.S.C. 78s(b)(1).

⁴ 17 CFR 240.19b-4.

⁵ Amendment No. 4 supersedes the original filing and Amendments No. 1, 2, and 3 in their entirety.

⁶ Securities Exchange Act Release No. 47676 (April 14, 2003), 68 FR 19865.

letters on the proposal.⁵ The Exchange filed Amendments No. 5 and 6 to the proposal on May 16, 2003⁶ and May 30, 2003,⁷ respectively. The CBOE also submitted a letter responding to the ISE Letter on May 16, 2003.⁸ This order approves the proposed rule change and Amendments No. 1, 2, 3, and 4; grants accelerated approval to Amendments No. 5 and 6 to the proposed rule change; and solicits comments from interested persons on Amendments No. 5 and 6.

II. Description of the Proposal

The Exchange proposes to implement the CBOE Hybrid System (“Hybrid” or

⁵ Letters from Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange (“ISE”), to Jonathan G. Katz, Secretary, Commission, dated May 13, 2003 (“ISE Letter”); and Philip D. DeFeo, Chairman and Chief Executive Officer, Pacific Exchange, Inc. (“PCX”), to Jonathan G. Katz, Secretary, Commission, dated May 21, 2003 (“PCX Letter”).

⁶ Letter from Steve Youhn, CBOE, to Deborah Flynn, Assistant Director, Division of Market Regulation (“Division”), Commission, dated May 15, 2003 (“Amendment No. 5”). Amendment No. 5 revises proposed CBOE Rule 6.13(b)(iii) to clarify that if a marketable balance remains after a split price execution, it would be booked automatically only if the order is eligible for book entry. Otherwise, the balance would route either to PAR or BART, or, at the order entry firms’ discretion, to the order entry firm’s booth printer. Amendment No. 5 also revises proposed CBOE Rule 7.4(a) to require electronic submission of orders or quotes for entry into the electronic book, and to require such orders and quotes to comply with format requirements prescribed by the Exchange. Finally, Amendment No. 5 moves the sentence, “Orders not eligible for automatic execution instead will route to PAR, BART, or, at the order entry firm’s discretion, to the order entry firm’s booth printer” from proposed CBOE Rule 6.13(b)(i)(B)(ii) to proposed CBOE 6.13(b)(i)(B), and rennumbers subsection (B) as subsection (C).

⁷ Letter from Steve Youhn, Attorney, CBOE, to Deborah Flynn, Assistant Director, Division, Commission, dated May 30, 2003 (“Amendment No. 6”). First, Amendment No. 6 amends proposed CBOE Rule 6.45A(a)(i) to clarify that only in-crowd DPMs can be considered to be “market participants.” Second, Amendment No. 6 amends proposed CBOE Rule 6.45A(c), regarding interaction of market participant’s quotes and/or orders with orders in electronic book, to clarify that a trade occurs when a market participant’s quote or order interacts with the order in the book; and that the CBOE would disseminate a last sale report at this point and decrement the disseminated quote to reflect the execution. Third, Amendment No. 6 describes in greater detail the ability of market makers to submit two-sided and one-sided quotes (referred to as orders). Fourth, Amendment No. 6 clarifies that the FPC generally has the discretion to determine whether to route orders through PAR or BART, and clarifies how the FPC would use that discretion. Fifth, Amendment No. 6 clarifies the routing process for orders that would be eligible for automatic execution when the CBOE is not at the NBBO. Sixth, Amendment No. 6 amends proposed CBOE Rule 6.45A(c) to clarify that customer orders would be the only type of order represented by floor brokers that would be eligible to participate in the N-second group.

⁸ Letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated May 15, 2003 (“CBOE Response Letter”).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Geraldine Brindisi, Vice-President and Corporate Secretary, Amex, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated April 16, 2003 (“Amendment No. 1”). In Amendment No. 1, the Amex replaced in its entirety the original proposed rule change.

⁴ See Securities Exchange Act Release No. 47725 (April 23, 2003), 68 FR 23337.

⁵ In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁶ 15 U.S.C. 78f.

⁷ 15 U.S.C. 78f(b)(5).

⁸ See Securities Exchange Act Release No. 31610 (December 16, 1992), 57 FR 61131 (December 23, 1992) (SR-Amex-92-34) (permanently approving

“Hybrid System”), an options trading platform that would combine the features of electronic and open outcry, auction market principles, while, at the same time, providing market makers the ability to electronically stream their own quotes. Today, CBOE’s disseminated quote represents, for the most part, only the DPM’s automatically generated quotations. Market makers are able to affect changes to that quote only in open outcry (or by putting up manual quotes). Hybrid would offer in-crowd market makers and in-crowd DPMs⁹ the opportunity to submit their own firm disseminated market quotes that represent their own trading interest.¹⁰ In addition, in-crowd floor brokers would be permitted to enter orders on behalf of their customers for display in the CBOE’s best bid or offer (“BBO”). Market makers would have the ability to stream quotes that reflect their individual trading interest.

Incoming electronic orders from public customers and non-market maker broker-dealers that automatically execute against market participants’ quotes would be allocated to the best quoters pursuant to a new trading algorithm. This “Ultimate Matching Algorithm” (“UMA” or the “allocation algorithm”) retains public customer priority and rewards market participants for quoting at the best price and for providing liquidity at the best price.

Hybrid also retains features of a floor-based, open outcry exchange. Order entry firms would continue to have the option of sending floor brokers into a trading crowd to request markets on behalf of their customers. Trading crowds, as is the case today, would continue to have the opportunity to offer price improvement to orders that are exposed to the open outcry, auction market environment.

Under Hybrid, non-market maker broker-dealers would have the same access to the automatic execution feature of Hybrid as public customers.¹¹ In this regard, non-market maker broker-dealers orders would be permitted to automatically execute against quotes and resting limit orders on the book, whether those orders are public customer orders or broker-dealer orders. Additionally, at the discretion of the

Floor Procedure Committee (“FPC”), broker-dealer orders would be eligible for placement into the electronic book, where they may be executed electronically.¹²

To implement Hybrid, the Exchange proposes to adopt several new rules (most notably, CBOE Rules 6.13 and 6.45A) and to amend several existing rules. New CBOE Rule 6.13 would replace the Exchange’s RAES Rule 6.8 for those classes in which Hybrid is operational and would govern the automatic execution of incoming electronic orders. Proposed CBOE Rule 6.45A would be the new priority and allocation rule and would codify UMA. A more complete description of the proposal is provided in Section IV, below.

This proposal would apply only to equity options. The Exchange proposes a rollout schedule to begin trading of equity option classes on Hybrid by May 30, 2003. New equity option classes would continue to be rolled out gradually as the Exchange and its membership become more familiar with the operation of the system. The determination of which classes to roll out, and when to roll them out, would be made by the Equity FPC. The Exchange plans to expand the rollout to the Top 200 classes by January 2004 and, by the fourth quarter of 2004, to expand the rollout to the 500 most active equity options. The Exchange intends to implement Hybrid floor-wide in all classes by the fourth quarter of 2006.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 5 and 6 to the proposed rule change, including whether Amendments No. 5 and 6 are 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, would be available for inspection and copying in the Commission’s Public Reference Room. Copies of such filing would also

be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2002-05 and should be submitted by June 30, 2003.

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a national securities exchange and, in particular, with the requirements of section 6(b) of the Act.¹³ Specifically, the Commission finds that approval of the proposed rule change, as amended, is consistent with section 6(b)(5) of the Act¹⁴ in that it is designed to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and in general, to protect investors and the public interest.

A. Automatic Executions

CBOE Hybrid would permit the automatic execution of incoming electronic customer and non-market maker broker-dealer orders in classes designated for trading on Hybrid. Pursuant to proposed CBOE Rule 6.13(b)(i)(C), two categories of orders would be eligible, for the same number of contracts, for automatic execution: orders from non-broker-dealer public customers and orders from non-market maker broker-dealers. The appropriate FPC would be permitted to determine that orders from market makers and specialists would also be eligible for automatic execution.¹⁵ Orders not eligible for automatic execution instead would route to PAR, BART, or, at the order entry firm’s discretion, to the order entry firm’s booth printer.¹⁶

¹³ 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁴ 15 U.S.C. 78f(b)(5).

¹⁵ CBOE market makers who are physically present in the trading crowd would be permitted to submit one-sided quotes (also referred to as an order) or two-sided quotes. See Amendment No. 6, supra note 7.

¹⁶ BART is the Booth Automated Routing Terminal that enables firms to maintain orders in electronic format. Orders routed to the firm’s booth, as opposed to BART, would print at the booth and must be handled by the firm manually. As is the case today, the FPC would have the discretion, on a class by class basis, to route orders to PAR or

⁹ See Amendment No. 6, supra note 7.

¹⁰ In-crowd floor brokers may represent orders on behalf of members, broker-dealers, public customers, and the firm’s proprietary account. Pursuant to CBOE Rule 6.75, floor brokers generally may not execute any orders for which they have been vested with the discretion to choose: the class of options to buy/sell, the number of contracts to buy/sell, or whether the transaction would be one to buy or sell. Unlike market makers and the DPM, floor brokers may not stream quotes.

¹¹ See proposed CBOE Rule 6.13(b)(i)(B)(1).

¹² See proposed CBOE Rule 7.4(a).

In addition, the appropriate FPC would determine, on a class-by-class basis, the maximum size of orders entitled to receive automatic execution through Hybrid. If the appropriate FPC determines to allow market makers and specialists to access the automatic execution feature of Hybrid, proposed CBOE Rule 6.13(b)(i)(C) would permit the FPC to establish the maximum order size eligibility for such orders at a level lower than the maximum order size eligibility for non-broker-dealer public customers and non-market-maker broker-dealers.

Under proposed CBOE Rule 6.13(b)(iii), eligible orders for a size greater than the disseminated size would be automatically executed up to the disseminated size. The balance of the order, if marketable, would be executed automatically at the revised disseminated price up to the revised disseminated size. If not marketable, the balance of the order would book electronically, if the order were eligible for book entry. Otherwise, the balance would route either to PAR or BART, or, at the order entry firm's discretion, to the order entry firm's booth printer.¹⁷

Pursuant to proposed CBOE Rule 6.13(b)(iv), when the CBOE quotation is inferior to the NBBO, eligible orders would not automatically execute and instead, would route to the DPM's PAR terminal or, at the order entry firm's discretion, to BART, for non-automated handling.¹⁸ Eligible orders received while the CBOE market is locked would be eligible for automatic execution on CBOE at the disseminated quote, provided that CBOE's disseminated quote is not inferior to the NBBO, in which case the order would route to the DPM's PAR terminal or, at the order entry firm's discretion, to BART, for non-automated handling.

In its comment letter, the ISE questions why "an FPC would establish a size limit for orders eligible for automatic execution under proposed Rule 6.13 when the size of market maker quotes is displayed and firm for certain

incoming orders."¹⁹ The ISE's comment suggested that, in its view, the requirements of the Quote Rule²⁰ and an exchange's automatic execution system parameters must necessarily be the same. The Quote Rule, however, does not require an automatic execution. For this reason, the Commission has previously approved exchange rules that establish automatic execution sizes that are different from the sizes for which responsible brokers or dealers are obligated under the Quote Rule.²¹

The ISE also argues that the size restrictions on orders eligible for automatic execution, together with "the requirement that broker-dealer orders and/or competing market maker orders must be represented in the trading crowd * * * raise best execution concerns not only for the orders represented in the trading crowd, but also for incoming electronic orders and orders on the electronic limit order book that may receive automatic executions at inferior prices."²² In response to this comment, CBOE notes that proposed CBOE Rule 6.13(b)(iv) expressly prohibits the automatic execution of orders at prices inferior to the NBBO and that orders do not lose this protection merely because they are executed manually instead of electronically.²³ The CBOE also notes that orders executed in open outcry actually have the potential opportunity to be executed at better prices than they would receive if executed electronically.²⁴ The Commission believes that the proposed rules are consistent with the Act. Brokers continue to have best execution obligations to their customers and must consider all facts and circumstances in determining where to route customers' orders.

Finally, CBOE notes that the ISE is incorrect in its statement that orders for competing market makers that are not eligible for automatic execution must be routed to a floor broker in the firm's

booth.²⁵ Pursuant to Proposed CBOE Rule 6.13(b)(i)(B), absent specific instructions by the order entry firm to the contrary, orders that are not eligible for automatic execution may route only to PAR or BART.

B. Priority and Allocation

1. Allocation of Incoming Electronic Orders

Under proposed CBOE Rule 6.45A, incoming electronic orders would be allocated to a market participant who is quoting or representing an order at the CBOE BBO using UMA for up to the size of its quote.²⁶ Public customer orders in the electronic book and at the BBO would always have priority. Multiple public customer orders in the electronic book at the same price would be ranked based on time priority.²⁷

A market participant quoting alone at the BBO would have priority and would be entitled to receive incoming electronic order(s) up to the size of its quote. When more than one market participant is quoting at the BBO, inbound electronic orders would be allocated pursuant to UMA. UMA allocates orders based on two separate components: parity (*i.e.*, multiple participants quoting at the best price) and depth of liquidity (*i.e.*, relative size of each market participant's quote).²⁸ Component A of the UMA is the parity component, which would treat as equal all market participants quoting at the relevant best bid or best offer. Accordingly, the percentage used for Component A is an equal percentage, derived by dividing 100 by the number of market participants quoting at the best price. Component B of the UMA is the size pro-rata component designed to reward and incent market participants to quote with size. The percentage used

²⁵ *Id.*

²⁶ If, pursuant to CBOE Rule 7.4(a), the appropriate FPC determines to allow broker-dealer orders to be placed in the electronic book, then, for purposes of this rule, the cumulative number of broker-dealer orders in the electronic book at the best price would be deemed one "market participant," regardless of the number of broker-dealer orders in the book. The allocation due the broker-dealer orders in the electronic book by virtue of their being deemed a "market participant" would be distributed among each broker-dealer order comprising the "market participant" based on UMA. See proposed CBOE Rule 6.45A(a)(i)(A)(2).

²⁷ If a public customer order in the electronic book matches, or is matched by, a market participant's quote, the public customer order would have priority and, the balance of the electronic order, if any, would be allocated based on UMA.

²⁸ UMA operates electronically and, as such, only market participants that are represented in the disseminated quote would participate in the allocation of incoming electronic orders. Multiple incoming orders would execute in accordance with CBOE Rule 8.51, Firm Disseminated Market Quotes.

BART. If market maker orders are not eligible for automatic execution, they would all route to PAR or they would all route to BART. The FPC could not determine to route, for example, orders for CBOE market makers that are not in the crowd to PAR, and competing market maker orders to BART. The CBOE represents that routing decisions would be changed infrequently. See Amendment No. 6, *supra* note 7.

¹⁷ See Amendment No. 5, *supra* note 6.

¹⁸ In these instances, the order would route to PAR, unless the order entry firm decides that these orders should route to BART, because routing to PAR would allow the DPM either to send an order through the options intermarket linkage or to execute the order at the better price. See Amendment No. 6, *supra* note 7.

¹⁹ See ISE Letter, *supra* note.

²⁰ 11Ac1-1 under the Act ("Quote Rule"), 17 CFR 240.11Ac1-1.

²¹ See, e.g., CBOE Rule 6.8(c)(v), which states that "[t]he appropriate FPC shall determine the size of orders eligible for entry into RAES." See also PCX Rule 6.76, which states that "[t]he maximum size of an inbound order that may be eligible for execution on PCX Plus . . . will initially be established by the LMM in the issue, subject to the approval of the Options Floor Trading Committee. Any request by the LMM for changes to the Maximum Order Size . . . must be approved by two Floor Officials, whose approval must be further ratified by the Options Floor Trading Committee."

²² See ISE Letter, *supra* note 6.

²³ See CBOE Response Letter, *supra* note .

²⁴ *Id.*

for Component B is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote. The final relative weighting of Components A and B would be determined by the appropriate FPC,²⁹ but initially, would be equal. The assigned weightings of Components A and B would be multiplied by the percentages derived for Components A and B, respectively, and then would be multiplied by the size of the incoming order.

In its comment letter, the ISE argues that the proposal "will allow an FPC to change the allocation algorithm in many different ways * * *" and that "[s]uch a broad range of allocation possibilities cannot be equally fair and equally provide the best incentives for competition."³⁰ In response to ISE's comment, the CBOE represents that changes to these weightings would be made very infrequently and would apply floorwide in all classes within that FPC's jurisdiction.³¹ The CBOE further notes that the proposal requires that changes to these weightings must be announced to Exchange members in advance of implementation. Thus, the CBOE concludes that there is no possibility of "gaming" the formulas to disproportionately benefit certain trading crowds.

As stated above, the proposed allocation algorithm consists of the weighting of two components: the parity component, which treats as equal all market participants quoting at the relevant best bid or best offer, and the size pro-rata component, which provides greater allocations to market participants with larger quotes. The Commission must consider whether each component and all possible combinations of each component are consistent with the Act. The Commission has previously approved allocation algorithms that provide an equal allocation to participants quoting at the best price, as well as algorithms that provide for size pro rata allocations.³² The Commission also believes that any combination of these two algorithms would be consistent with the Act. In addition, the Commission believes that the proposed Hybrid System, including the proposed allocation algorithm, should substantially enhance incentives to quote competitively by providing market participants with the ability to

independently submit their quotes and then rewarding market participants that quote at the best price with an allocation of the resulting trade.³³

Finally, although it is not unlawful for a market maker to take the prices offered by its competitors into account when setting its own prices, or to follow or copy prices of its competitors, such a decision must be a unilateral business judgment not intended to harass or punish a competitor for improving prices or otherwise acting competitively and not the result of collusive agreement. Accordingly, the Commission expects that the CBOE will surveil its market to ensure that market makers are not coordinating quotes in the Hybrid System or engaging in other anticompetitive conduct.

2. Allocation of Orders Represented in the Trading Crowd by Floor Brokers

Orders represented in the trading crowd would first be executed against public customer orders in the electronic book. Multiple public customer orders in the electronic book at the same price would be ranked based on time priority.³⁴

After public customer orders on the book at the best price are exhausted, the method for allocating the remainder of orders that are represented in the trading crowd by floor brokers would depend upon whether there were any book market participants ("BMP")³⁵ quoting at the prevailing price. If there were no BMP present at the prevailing price, open outcry orders would be allocated pursuant to existing CBOE Rule 6.45(a) and (b). If there were a BMP quoting at the prevailing price, open outcry orders would be allocated as follows: If two or more bids (offers) represent the best price, priority would continue to be afforded in the sequence in which the bids (offers) were made, subject to the restriction that the first market participant to verbally respond would be entitled to 70% of the order.

³³ The Exchange has submitted the proposed rule change pursuant to subparagraph IV.B.h.(i)(aa) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, which required the CBOE (as well as other floor-based option market exchanges) to adopt new, or amend existing rules to substantially enhance incentives to quote competitively and substantially reduce disincentives to act competitively.

³⁴ See proposed CBOE Rule 6.45A(b)(i)(A).

³⁵ If, pursuant to CBOE Rule 7.4(a), the appropriate FPC determines to allow broker-dealer orders to be placed in the electronic book, then, for purposes of proposed CBOE Rule 6.45A(b), the cumulative number of broker-dealer orders in the electronic book at the best price would be deemed one BMP, regardless of the number of broker-dealer orders in the book.

The second market participant to verbally respond (if ascertainable) would be entitled to 70% of the remainder of the order (*i.e.*, 70% of 30%). The balance of the order would be apportioned equally among the remaining market participants verbally bidding (offering) at the same price and the BMP. The portion allocated to the BMP would be distributed among each book market participant pursuant to the UMA.

If, at any point, the sequence in which market participants verbally respond is not ascertainable, any remaining balance of an incoming order would be apportioned equally among the remaining market participants bidding (offering) at the same price and, if applicable, the BMP. If a market participant declines to accept any portion of the available contracts, any remaining contracts would be apportioned equally among the other participants who bid (offered) at the best price (including the book market participant, if applicable) at the time the market was established, until all contracts have been apportioned.

The Commission believes that the proposed rules governing allocation of orders represented in the trading crowd are consistent with the Act.

3. Interaction of Market Participant's Quotes/Orders with Orders in the Book

Under proposed CBOE Rule 6.45A(c), market participants would be permitted to submit orders or quotes electronically to trade with orders in the electronic book. However, for purposes of proposed CBOE Rule 6.45A(c), a floor broker market participant would be permitted only to represent as agent customer orders.³⁶ When a market participant's quote or order interacts with the order in the book, a trade occurs, and CBOE would disseminate a last sale report, and the size of the order would be decremented to reflect the execution.³⁷ If only one market participant submits an electronic order or quote to trade with an order in the electronic book, that market participant would be entitled to receive an allocation of that order in the electronic book up to the size of the market participant's quote or order. If, however, more than one market participant submits a quote or order to trade with the book within a period of time not to exceed 5-seconds³⁸ of the first market

³⁶ See Amendment No. 6, *supra* note 7.

³⁷ *Id.*

³⁸ This N-second period is configurable by the appropriate FPC but would never exceed 5-seconds. Any reduction of this N-second period (or subsequent increase) would be announced to the membership in advance of implementation via

²⁹ See CBOE Response Letter, *supra* note 8.

³⁰ See ISE Letter, *supra* note 5.

³¹ See CBOE Response Letter, *supra* note 8.

³² See PCX Rule 6.75(c); CBOE Rule 6.45(a)(ii)(2); and PCX Rule 6.76(a)(4).

participant to submit an order ("N-second group"), each member of the N-second group would be entitled to share in the trade with the electronic book pursuant to the allocation algorithm described below.³⁹

Component A of the proposed allocation algorithm is an equal percentage based on the number of market participants in the N-second group. Component B of the proposed allocation algorithm is that percentage that the order or quote of each market participant in the N-second group represents relative to the total number of contracts of such orders or quotes. The final relative weighting of Components A and B would be determined by the appropriate FPC,⁴⁰ but initially, would be equal. The assigned weightings of Components A and B would be multiplied by the percentages derived for Components A and B, respectively, and then would be multiplied by the size of the incoming order.

If a DPM were eligible for an allocation by virtue of being a member of the N-second group, the DPM would be entitled to receive an allocation equal to the amount it would be entitled to pursuant to the DPM participation right established pursuant to CBOE Rule 8.87 (and Regulatory Circulars issued thereunder), discussed below. The DPM's entitlement percentage is expressed as a percentage of the remaining quantity after all public customer orders in the electronic book have been executed.

In its comment letter, ISE raises several concerns about the proposed N-second period.⁴¹ First, ISE questions whether a marketable public customer order that is received during the N-second period would receive an automatic execution against orders in the limit order book during the N-second period. The ISE also questions whether, if the incoming order trades against orders in the limit order book and the best price moves, the interest in the N-second group would be automatically cancelled.⁴²

The Commission believes that ISE's questions are answered by CBOE's amendment clarifying when a trade occurs in the context of an N-second

group transaction.⁴³ Specifically, as amended, proposed CBOE Rule 6.45A(c) indicates that a trade would occur when a market participant's quote or order interacts with the order in the book. At this point, CBOE would disseminate a trade report and decrement its disseminated quote to reflect the execution. The N-second group is relevant only to determining the appropriate allocation of the trade among market participants. According to the CBOE, the N-second period prevents millisecond priority by giving a form of parity to market participant orders submitted at virtually the same time. Moreover, because the N-second group is relevant only to the allocation of the trade, members of the N-second group would not have an opportunity to cancel trades.⁴⁴

In addition, ISE questions how a participant in the N-second group representing a customer order would be treated.⁴⁵ CBOE's amendment also clarifies that if a floor broker agent submits a customer order to buy (sell) the book, and that order is first in time (*i.e.*, ahead of all other market participants), it would have priority.⁴⁶ CBOE's amendment further clarifies that a floor broker submitting a customer order after a market participant would become part of the N-second group.⁴⁷ Floor broker handheld quoting/order entry terminals provide floor brokers with the ability to designate orders as customer orders.⁴⁸

³⁹ See Amendment No. 6, *supra* note 7.

⁴⁰ See CBOE Response Letter, *supra* note 8.

⁴¹ *Id.*

⁴² See Amendment No. 6, *supra* note 7.

⁴³ *Id.* The Hybrid System, at least temporarily, would not recognize in-crowd orders from floor broker handheld devices for purposes of allowing these orders to participate in the N-second group. To address this systems limitation, the Exchange proposes to designate in each trading crowd "Temporary Order Access Terminals" ("T-OATs") that would allow floor brokers to enter customer orders that would be eligible to participate in the N-second group. The CBOE represents that these terminals would provide to floor brokers the same functionality in terms of order entry that in-crowd market makers currently have. The CBOE also represents that these T-OATs would be reserved exclusively for the use of floor brokers holding customer orders and would be conveniently located in the trading pit such that they are readily available and easily accessible. The CBOE commits to place at least one T-OAT in each trading pit in which Hybrid is operational and further commits to provide as many T-OATs as are necessary to accommodate demand. The CBOE will provide these T-OATs for floor brokers' use until the above-mentioned Hybrid System limitation is resolved in such a manner that floor brokers have direct order entry access via floor broker workstations. The Exchange will continue to provide T-OATs until either November 28, 2003 or until the Hybrid System is capable of accepting orders from floor broker workstations, whichever occurs first. See proposed CBOE Rule 6.45A(c)(iv).

⁴⁴ *Id.*

Finally, the ISE questions the discretion given the FPC with respect to the length of the N-second interval. The Commission notes that the FPC may only shorten the length of this interval and, as represented by CBOE, any changes to the N-second interval would be announced to the membership in advance of implementation and would apply uniformly across all classes under the FPC's jurisdiction.

Accordingly, the Commission believes that this proposed algorithm is consistent with the Act and should ensure that additional market participants have an opportunity to interact with orders resting on the Exchange's electronic book.

4. Quotes Interacting with Quotes

Because Hybrid allows the simultaneous entry of quotes by multiple market makers, there may be instances where quotes become locked. If an in-crowd market maker's (including the DPM) disseminated quote were to interact with the disseminated quote(s) of another in-crowd market maker (including the DPM), resulting in the dissemination of a "locked" quote, the following would occur:

(A) The Exchange would disseminate the locked market and both quotes would be deemed "firm" disseminated market quotes.

(B) The market makers whose quotes are locked would receive a quote update notification advising that their quotes are locked.

(C) A "counting period" would begin during which market makers whose quotes are locked may eliminate the locked market.⁴⁹ Provided, however, that in accordance with subparagraph (A) above, a market maker would be obligated to execute customer and broker-dealer orders eligible for automatic execution pursuant to proposed CBOE Rule 6.13 at his disseminated quote in accordance with CBOE Rule 8.51. During the "counting period," market makers would continue to be obligated for one contract in open outcry to other market makers, in accordance with CBOE Rules 8.51 and 6.48. If, at the end of the counting

⁴⁹ For the first 60 days after a class begins trading on the Hybrid System, the length of the "counting period" for that particular class would not exceed ten seconds. For the next 60 days thereafter (*i.e.*, days 61-120) the length of the "counting period" would not exceed seven seconds in that class. Commencing on the 121st day after a class begins trading on the Hybrid System, the length of the "counting period" would not exceed four seconds in that class. Beginning April 1, 2004, all classes trading on Hybrid would be subject to a counting period not to exceed four seconds. The appropriate FPC may shorten the duration of the "counting period."

Regulatory Circular. Furthermore, this time-period would apply uniformly among all classes under the FPC's jurisdiction. See CBOE Response Letter, *supra* note 8.

³⁹ See Amendment No. 6, *supra* note . The trade occurs when the first market participant's quote or order interacts with the order in the book, not at the expiration of the N-second period.

⁴⁰ As stated above, CBOE represents that these weightings would be changed very infrequently. See CBOE Response Letter, *supra* note 8.

⁴¹ See ISE Letter, *supra* note 5.

⁴² *Id.*

period, the quotes remain locked, the locked quotes would automatically execute against each other in accordance with the allocation algorithm described above in proposed CBOE Rule 6.45A(a).

The Hybrid System would not disseminate an internally crossed market (*i.e.*, the CBOE bid is higher than the CBOE offer). If a market maker were to submit an incoming quote that would cross an existing quote, the Exchange would automatically alter the incoming quote such that it locks the existing quote, at which point the locked quotes would be treated in accordance with the procedures described above. The Exchange would notify the second market maker that its quote has been changed.⁵⁰ The Commission believes that the proposed provisions are consistent with the Quote Rule. Market makers would continue to be required to honor their quotes and, thus, would be obligated to execute incoming orders pursuant to proposed CBOE Rule 6.13. The Commission notes that the market makers whose quotes are locked would continue to be obligated under the Quote Rule for at least one contract to each other during the counting period. At the end of the counting period, assuming neither market maker has changed its quotes, the market makers' quotes would execute against each other in all series.

PCX argues⁵¹ that these proposed rules are inconsistent with the Options Intermarket Linkage Plan ("Linkage Plan").⁵² The Commission notes that the Linkage Plan's admonition to avoid the dissemination of locked and crossed markets⁵³ would apply to CBOE Hybrid. The Commission believes that the proposed "counting period" provides a reasonable method for market makers that lock or cross a

market to unlock or uncross the market, as required by the Linkage Plan.⁵⁴ Importantly, during the "counting period," the market makers whose quotes are locked would remain obligated to execute customer and broker-dealer orders eligible for automatic execution at the locked price.⁵⁵

PCX also argues that the proposal would "exacerbate the occurrence of * * * non-disclosed crossed markets to the detriment of public investors."⁵⁶ The Linkage Plan requires the CBOE and the other options exchanges to avoid the dissemination of locked or crossed markets. If a market maker were to submit an incoming quote that would cross an existing quote, the Exchange proposed to automatically alter the incoming quote such that it locks the existing quote, thus avoiding the dissemination of a crossed market. The Commission believes the proposed rules regarding crossed markets provide a reasonable method of avoiding the dissemination of inverted markets.

5. DPM's Participation Entitlement

Under proposed CBOE Rule 6.45(a)(i)(C), if a DPM is eligible for an allocation pursuant to the operation of the UMA described above, the appropriate FPC would determine whether a DPM's allocation would be:⁵⁷

(A) the greater of the amount it would be entitled to pursuant to the DPM participation right established pursuant to CBOE Rule 8.87 (and Regulatory Circulars issued thereunder)⁵⁸ or the amount it would otherwise receive pursuant to the operation of the proposed allocation algorithm described above; or

(B) the amount it would be entitled to pursuant to the DPM participation right established pursuant to CBOE Rule 8.87 (and Regulatory Circulars issued thereunder).⁵⁹

⁵⁴ *Id.*

⁵⁵ See proposed CBOE Rule 6.45A(d).

⁵⁶ See PCX Letter, *supra* note 5.

⁵⁷ See proposed CBOE Rule 6.45A(a)(i)(C). Each pronouncement regarding which allocation alternative to be used would be made via Regulatory Circular.

⁵⁸ CBOE Rule 8.87 states that "[s]ubject to the review of the Board of Directors, the MTS Committee may establish from time to time a participation entitlement formula that is applicable to all DPMs." Any changes to this formula are required to be filed as a proposed rule change pursuant to Section 19(b) of the Act. Currently, a DPM's participation entitlement is 40% when there are two market makers at parity with the DPM and 30% when there are three or more market makers at parity with the DPM. See Securities Exchange Act Release No. 43750 (December 20, 2000), 65 FR 82420 (December 28, 2000) (SR-CBOE-00-52).

⁵⁹ Due to a systems limitation, the Exchange initially would use method two and set the DPM's allocation at the amount it would be entitled to

In either case, the DPM's entitlement cannot exceed the size of the DPM's quote.

ISE expressed its concern that "the ability to * * * decide between alternative DPM entitlement formulas might be used to protect the DPM or maximize its participation based upon the level of competition it faces."⁶⁰ In response, the CBOE states that the Hybrid filing does not propose to change the level of the participation right guaranteed to DPMs and that changes to the DPM participation right are governed by CBOE Rule 8.87 and are subject to Board review. The Commission also notes that any changes to the DPM's participation rights must be filed with the Commission as a proposed rule change pursuant to Section 19(b) of the Act.

In addition, CBOE notes that the decision by the FPC regarding the allocation a DPM would receive under proposed CBOE Rule 6.45A(i)(C) would be in effect floorwide in all classes under the FPC's jurisdiction and would be announced to the membership in advance of implementation. CBOE believes this would preclude switching between the two allocation alternatives on a class basis based upon the level of competition faced by a DPM.

The Commission recognizes that a large guaranteed participation right would 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 lead 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.⁶¹ 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 consistent with the Act.⁶² The

pursuant to CBOE Rule 8.87 (and Regulatory Circulars issued thereunder).

⁶⁰ See ISE Letter, *supra* note 5.

⁶¹ 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 Phlx to establish an 80% specialist guarantee would be consistent with the Act).

⁶² See, e.g., Securities Exchange Act Release No. 45936 (May 15, 2002), 67 FR 36279, 26280 (May 23, 2002) (SR-CBOE-2002-10) (approving participation entitlements that range from 34 percent to 40 percent for the DPM providing the primary quote feed, depending on the total number of appointed market makers in the option); Securities Exchange Act Release No. 42835 (May 26, 2000), 65 FR 35683, 35685-66 (June 5, 2000) (SR-CBOE-99-10) (approving DPM guarantee for crossed orders that, when combined with the percentage crossed by the

⁵⁰ During the lock period, if the first quote is cancelled or changed, the second quote would be restored to its original value. For example, assume MM A quotes 1.00-1.20 (which is the CBOE's disseminated quote) and MM B submits a 1.25-1.40 quote. Because MM B's quote would invert MM A's disseminated quote, MM B's quote would be changed to 1.20-1.40 and the disseminated quote would be 1.20-1.20. If during the lock period, MM A cancels its quote, MM B's quote (which is currently 1.20-1.40) would revert to 1.25-1.40.

⁵¹ See PCX Letter, *supra* note 5.

⁵² See Securities Exchange Act Release Nos. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (order approving the Linkage Plan submitted by American Stock Exchange LLC, Chicago Board Options Exchange, Inc. and International Securities Exchange, Inc.); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000) (order approving the PCX as participant in Options Intermarket Linkage Plan); and 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000) (order approving Philadelphia Stock Exchange, Inc. as participant in the Linkage Plan).

⁵³ See Section 7(a)(i)(C) of the Linkage Plan.

Commission notes that under the proposed rules, the most to which the DPM would be entitled would be either the guarantee, which is capped at 40%, or the amount to which it would be entitled pursuant to the proposed allocation algorithm, discussed above. This approach is consistent with rules previously approved by the Commission.⁶³

C. Orders on the Book

The Exchange proposes to amend CBOE Rule 7.4(a) to expand the types of orders eligible for entry into the electronic book.⁶⁴ Market participants would be permitted to place orders in the book (in those classes in which Hybrid is operational.) Proposed paragraph (a)(1) to CBOE Rule 7.4 would enable the FPC to allow all broker-dealer orders to be book eligible or, to allow orders from those broker-dealers that are not market makers or specialists to enter the book. This proposed rule also would require members submitting orders or quotes for entry into the electronic book to do so electronically and require them to comply with such format requirements as may be prescribed by the Exchange.⁶⁵

ISE contends that the proposal allows "an FPC to distinguish between broker-dealer orders and competing market maker orders on a class basis, and to decide whether one or both categories of orders may be permitted on the book and/or be eligible for automatic execution."⁶⁶ In its response, CBOE states that the Hybrid proposal does not discriminate against competing market maker orders because they are treated

floor broker, cannot exceed 40% of the original order (after relevant public customer orders have been satisfied); and Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11398 (March 2, 2000) (approving International Securities Exchange's application for registration as a national securities exchange, which contains a 40% participation right for facilitating EAMS); See also Phlx 80/20 Proposal, *supra* note 61.

⁶³ See Supplementary Material .01(b) to ISE Rule 713, which states that "[i]f the Primary Market Maker is quoting at the best price, it has participation rights equal to the greater of (i) the proportion of the total size at the best price represented by the size of its quote, or (ii) sixty percent (60%) of the contracts to be allocated if there is only one (1) other Non-Customer Order or market maker quotation at the best price, forty percent (40%) if there are two (2) other Non-Customer Orders and/or market maker quotes at the best price, and thirty percent (30%) if there are more than two (2) other Non-Customer Orders and/or market maker quotes at the best price." See also PCX Rule 6.76(a)(2)(C)(iii), which states that the "LMM will be allocated a number of contracts equal to the greater of their guaranteed participation or their 'size pro rata' allocation * * *."

⁶⁴ Currently, only public customer orders are eligible for entry in the book.

⁶⁵ See Amendment No. 5, *supra* note 6.

⁶⁶ See ISE Letter, *supra* note 5.

the same way that orders for CBOE market makers who are not physically present in the trading crowd are treated.⁶⁷ In this regard, a CBOE market maker that is not physically present in the trading crowd would be eligible to receive automatic executions in that class only if all other market makers (including competing market makers) were also eligible.⁶⁸

However, a market maker who is physically present in the trading crowd would be permitted to submit one-sided quotes (also referred to as an order) or two-sided quotes.⁶⁹ These one and two-sided quotes would be treated in the same manner by the Hybrid System.⁷⁰ Such quotes would route directly to the CBOEdirect platform; would have the same participation entitlements in UMA; would be eligible to participate in the N-second group as described in proposed CBOE Rule 6.45A(c); and would be subject to proposed CBOE Rule 6.45A(d) if they locked the quote of another market maker.⁷¹ Furthermore, an in-crowd market maker would be required to be firm pursuant to the Quote Rule for a one-sided quote to the same extent he or she would be for a two-sided quote.⁷²

The Commission believes that the proposal does not unfairly discriminate against competing market makers and may enhance access to the book.

D. Firm Quotations

The Exchange proposes to amend CBOE Rule 8.51(a)(1) to clarify that in Hybrid classes, the market participant who submits a quote that is disseminated would be the responsible broker or dealer for that quote for purposes of the Exchange's rule and the Quote Rule. Proposed subparagraph (c)(1)(a)(i) to CBOE Rule 8.51 states that the firm quote requirement for customer orders would be the size disseminated to vendors. In subparagraph (a)(ii), the Exchange proposes to clarify that the firm quote requirement for broker-dealer orders would be the lesser of the size it disseminates to vendors or periodically publishes in a different manner. This proposed rule is almost identical to the CBOE's current rule, except that it provides flexibility to allow the Exchange to disseminate its broker-dealer firm quote size (rather than to periodically publish it).

In addition, CBOE proposes a change to Interpretation .10 to CBOE Rule 8.51

to clarify the timing of when an order has been presented to a responsible broker or dealer. Currently, because the trading crowd as a whole is the responsible broker or dealer, an order is considered to be presented to the responsible broker or dealer at the time it is received on a PAR station. This interpretation would remain the same for non-Hybrid classes. For Hybrid classes, an order received on a PAR station is presented to a responsible broker or dealer that is not the DPM when the order is announced to the trading crowd.⁷³ However, an order is considered presented to the DPM at the time of receipt of the order on PAR. Thus when an order is received on PAR when the disseminated quote represents the DPM and other market makers, there would be two separate times when the order has been presented for Quote Rule purposes: the order would be presented to the DPM at the time the order is received on PAR, while the order would be presented to another responsible broker or dealer when the order is announced to the crowd.

ISE argues that "the proposal changes the point at which firm quote obligations attached to orders represented by floor brokers to the time they are presented to the crowd so there is greater potential for the quote to have changed from the time the order was received at the CBOE to the time it is walked into the crowd." The Quote Rule, among other things, requires a responsible broker or dealer to execute orders presented to it by another broker-dealer, at a price at least as favorable as the responsible broker or dealer's published bid or offer. The Commission believes that CBOE's proposed rule amendment is consistent with the Quote Rule because a responsible broker or dealer in the trading crowd would not be "presented" with an order until it is announced to the crowd.

The Commission, nonetheless, has concerns about the potential for responsible brokers or dealers to improperly avoid their Quote Rule obligations. The Commission expects the CBOE to surveil not only for violations of the Quote Rule by the DPM and/or other responsible brokers or dealers, but also, for the DPM's handling

⁷³ In Amendment No. 4, the Exchange noted that market makers in the crowd have no control over PAR and no access to PAR and would be unaware that an order resides on PAR until that order is announced to them. Currently, even though a market maker may be unaware of the receipt of an order on PAR, because the disseminated quote represents the entire trading crowd, the entire crowd is deemed to receive the order upon receipt of the order on PAR. In Hybrid, each market maker has its own quote. See Amendment No. 4, *supra* note 3.

⁶⁷ See CBOE Response Letter, *supra* note 8.

⁶⁸ *Id.*

⁶⁹ See Amendment No. 6, *supra* note 7.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

of orders received by it for presentation to responsible brokers or dealers. The Commission intends to monitor closely the CBOE's efforts in this regard.

E. Obligations of Market Makers

CBOE Rule 8.7 governs market maker obligations. Market makers on the CBOE Hybrid System would continue to be subject to the obligations imposed by this rule, as amended. The proposed change to Section (b)(ii) of CBOE Rule 8.7 clarifies that market makers would be obligated to honor their quotes for up to their disseminated size, in accordance with the Quote Rule. In addition, market makers would be deemed the "responsible broker or dealer" for quotes they cause to be disseminated.

Under Hybrid, market makers would be able to quote verbally in open outcry in response to a request for a market, or to quote electronically (or submit orders electronically) by use of an exchange-approved quoting device. CBOE Rule 8.7 also would clarify that market makers must be physically present in the trading crowd to quote and submit orders. Market maker quotes would be required to be for ten contracts or more. This size obligation would apply only to a market maker's initial undecrement quote.

In addition, the Exchange proposes new paragraph (d) to CBOE Rule 8.7, which would establish additional obligations for market makers trading Hybrid classes.⁷⁴ Specifically, if a market maker on the CBOE Hybrid System transacts more than 20% of its contract volume electronically in an appointed Hybrid class during any calendar quarter, the market maker would be required to maintain continuous, two-sided quotes for at least ten contracts in a designated percentage of series within the class, depending on the percentage of the market maker's contract volume transacted electronically.⁷⁵ The following schedule would apply:

% of Overall Class Volume Transacted on CBOE During the Previous Quarter that was Transacted Electronically	Electronic Quoting % Requirement (Percentage of series)
50 or Below	20
51-75	40
Above 75	60

Such market makers also would be required to provide a two-sided market for a minimum of ten contracts in response to any request for quote by a floor broker or DPM representing an

^{74, 75} The proposed obligations in paragraph (d) would be applicable on a per class basis and would apply only to market makers trading on the CBOE Hybrid System and only in those Hybrid classes.

order as agent. Finally, such market makers would be required to comply with the quote-width requirements contained in CBOE Rule 8.7(b)(iv).

Market makers that transact 20% or less of their contract volume electronically would be required to provide a two-sided market for a minimum of ten contracts in response to any request for quote by a floor broker or DPM representing an order as agent. Such verbal quotes would be required to comply with the quote-width requirements in CBOE Rule 8.7(b)(iv). These market makers' electronic quotes, however, would not be required to comply with the quote-width requirements of CBOE Rule 8.7(b)(iv). Although these market makers would not be obligated to quote electronically in any designated percentage of series within that class, any volume transacted electronically by such market maker would not count towards their in-person requirement in CBOE Rule 8.7.03(B).⁷⁶

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 of the Board of Governors of the Federal Reserve System 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.⁷⁷ The Commission believes that a 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, by excluding electronic transactions from satisfying a market maker's in-person requirements where the market maker transacts only 20% or less of its contract volume electronically and is not required to continuously quote or comply with quote-width requirements, the Commission believes that CBOE's rules impose such affirmative obligations on CBOE Hybrid market makers.

V. Accelerated Approval of Amendments No. 5 and 6

The Commission finds good cause for approving Amendments No. 5 and 6 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the **Federal Register** pursuant to Section 19(b)(2) of the Act.⁷⁸ Amendments No. 5 and 6 merely make clarifications to the proposed rule text in response to

⁷⁶ All market makers electronically quoting in a Hybrid class would be required to post an initial undecrement bid or offer of at least ten contracts.

⁷⁷ See 12 CFR 221.5(c)(6).

⁷⁸ 15 U.S.C. 78s(b)(2).

comments made in the ISE Letter and by Commission staff. Therefore, the Commission believes that accelerated approval of Amendments No. 5 and 6 is appropriate.

VI. Conclusion

For the foregoing reasons, 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, and, in particular, with section 6(b)(5) of the Act.⁷⁹

It is therefore ordered, pursuant to section 19(b)(2) of the Act,⁸⁰ that the proposed rule change (SR-CBOE-2002-05) and Amendments No. 1, 2, 3, and 4 are approved, and that Amendments No. 5 and 6 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸¹

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47951; File No. SR-CHX-2003-13]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Stock Exchange, Incorporated To Extend a Pilot Rule Interpretation Relating To Trading of Nasdaq/NM Securities in Subpenny Increments

May 30, 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 May 28, 2003, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed the proposal pursuant to section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6)⁴ thereunder, which renders the proposal effective upon filing with the Commission. The Commission is

⁷⁹ 15 U.S.C. 78f(b)(5).

⁸⁰ 15 U.S.C. 78s(b)(2).

⁸¹ 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). The Commission waived the 5-day pre-filing notice requirement.