

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

### I. Description of the Proposal

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

The Exchange commenced operating CBOEdirect as a pilot trading system in October 2001 pursuant to rule 19b-5 under the Act<sup>8</sup> and currently is used to

trade three classes of index options during an early morning session. CBOEdirect 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").<sup>9</sup> An SBT trader may connect to CBOEdirect from any place in the United States where it has a workstation and communication link to the Exchange.<sup>10</sup> 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 CBOEdirect; only an SBT market maker may enter quotes.<sup>11</sup> 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.<sup>12</sup>

A concept central to the operation of CBOEdirect 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 CBOEdirect may be established by an unrelated bid and offer. See CBOE rule 44.4(b). The appropriate Market Performance

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.

<sup>9</sup> See CBOE rule 41.2.

<sup>10</sup> See CBOE rule 41.3.

<sup>11</sup> 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).

<sup>12</sup> See notice, *supra* note 4, 67 FR at 31037-38.

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")<sup>13 14</sup> in an effort to establish a legal width market.

CBOEdirect 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.<sup>15</sup> The Help Desk would have the authority to send a Special RFQ to the SBT market makers that would require a response.<sup>16</sup> 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, CBOEdirect 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,<sup>17</sup>

<sup>13 14</sup> See CBOE rule 40.1(m).

<sup>15</sup> See CBOE rule 43.7(b).

<sup>16</sup> See *id.*; CBOE rule 40.1(n).

<sup>17</sup> See CBOE rule 40.1(l) (definition of "regular trading hour session").

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

<sup>4</sup> See Securities Exchange Act Release No. 45829 (April 25, 2002), 67 FR 31002 ("Notice").

<sup>5</sup> 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.

<sup>6</sup> 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. Jensen, Division of Market Regulation, Commission, to Angelo Evangelou, Legal Division, CBOE, dated March 31, 2003.

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

<sup>8</sup> 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 CBOEdirect. 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.