

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

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).

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).