

(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.