

environment for trades to occur on the floor of the Exchange. The text of the proposed rule change is available at the Office of the Secretary, CBOE, and at the Commission.

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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange hereby proposes the introduction of the CBOE Hybrid System ("Hybrid" or "Hybrid System"), a revolutionary trading platform that will alter the fundamental way in which the Exchange conducts business. When operational, Hybrid will combine the features of electronic trading with the benefits of open outcry, auction market principles to form the most dynamic trading platform in the options industry.

Hybrid merges the electronic and open outcry trading models while at the same time it offers market participants the ability to stream electronically their own quotes. Today, CBOE's disseminated quote represents, for the most part, the DPM's autoquote price and market makers are able to affect changes to that quote in open outcry (or by putting up manual quotes). Hybrid will offer market participants (which are defined as in-crowd market makers, in-crowd DPMs, and in-crowd floor brokers) the opportunity to submit their own firm disseminated market quotes that represent their own trading interest.⁴ Whereas there currently is only one autoquote price comprising the CBOE disseminated quote, Hybrid will allow for the introduction of multiple

quotes in the quoting equation. Market makers will have the ability to stream quotes that reflect their individualized trading interest.

Incoming electronic orders from public customers and certain types of broker-dealers that execute against market participants' quotes will be allocated to the best quotes pursuant to a novel and unique trading algorithm. This "Ultimate Matching Algorithm" ("UMA" or the "Algorithm") retains public customer priority and rewards those market participants pursuant to a formula that balances the concepts of quoting at the best price with providing liquidity at the best price. The result will be substantially enhanced incentives for market participants to quote competitively and substantially reduced disincentives to quote competitively.⁵ Indeed, the ability to stream electronic quotes combined with the ability to receive electronic and instantaneous allocations of incoming orders will reward market participants that quote at the best price. The Exchange believes that Hybrid, with its ability to allow multiple quotes and instantaneous allocations, may have the attendant benefit of tightening the Exchange's best disseminated quote. Whereas the Exchange's current disseminated quote, which is comprised of only one electronic input, may be replaced by a disseminated quote that reflects multiple inputs, the Exchange expects that spread widths may decline and liquidity may increase.

Hybrid also retains the benefits inherent in a floor-based, open outcry exchange. Order entry firms will continue to have the ability to have their floor brokers walk into a trading crowd and request markets on behalf of their customers. Trading crowds, as is the case today, may continue to offer price improvement to orders of size, complex orders, and other orders that are exposed to the open outcry, auction market environment. The opportunity for market participants to offer price improvement is a concept that exists only in extremely limited instances on all-electronic exchanges. The CBOE Hybrid System will enhance the ability of order entry firms to satisfy their due

diligence and best-execution obligations by providing them with a trading platform that provides efficient and instantaneous electronic executions when CBOE is the NBBO, along with the opportunity for price improvement.

Hybrid will also offer improved access to the broker-dealer community. In this respect, non-market maker broker-dealers will have the same access to the electronic execution feature of Hybrid that public customers will enjoy in designated classes. This will allow eligible broker-dealers to receive more automatic executions of the orders they route to CBOE. Additionally, the Hybrid rules for the first time allow for the "opening of the book" to certain types of broker-dealer orders. Accordingly, these broker-dealer orders will be eligible for placement into the electronic book against which they may be executed electronically. Finally, Hybrid also allows for the opportunity for broker-dealers to electronically access the limit order book (*i.e.*, buy or sell the book) in eligible classes. This feature will allow for the automatic execution of broker-dealer orders against resting limit orders in the book, whether they are public customer or broker-dealer orders in the book. Taken together, these features greatly enhance the handling of broker-dealer orders, thereby making the Exchange more broker-dealer friendly.

To implement Hybrid the Exchange proposes the adoption of several new rules (most notably CBOE Rules 6.13 and 6.45A) and the amendment of several existing rules. New CBOE Rule 6.13 replaces the Exchange's RAES Rule 6.8 for those classes in which Hybrid is operational and will govern the automatic execution of incoming electronic orders. Proposed CBOE Rule 6.45A is the new priority and allocation rule and codifies UMA. Together, these rules form the backbone of a trading system that will provide investors with deeper and more liquid markets, will provide market participants with substantially enhanced incentives to quote competitively, will greatly expand broker-dealer access, and will provide order entry firms with a trading platform CBOE believes is most conducive to satisfying their best execution and due diligence obligations.

This proposal will only apply to equity options. Accordingly, the Exchange proposes a rollout schedule that will see the introduction of equity option classes trading on Hybrid by May 30, 2003. New equity option classes will continue to be rolled out gradually as the Exchange and its membership become more familiar and acquainted with the operation of the system. The determination of which classes to roll

⁴ In this respect, in-crowd floor brokers may represent orders on behalf of members, broker-dealers, public customers, and the firm's proprietary account. Pursuant to 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 shall be one to buy or sell. Floor brokers may not stream quotes.

⁵ Subparagraph IV.B.h(i)(aa) of the Commission's September 11, 2000 Order ("Order") requires the Exchange to "adopt new, or amend existing, rules concerning its automated quotation and execution systems which substantially enhance incentives to quote competitively and substantially reduce disincentives for market participants to act competitively." Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. Securities Exchange Act Release No. 43268 (September 11, 2000).