

Electronic Book Order(s) Size	*	(Equal percentage based on number of members of "N-second group") (Component A)	+	(Size pro-rata percentage based on size of orders of N-second group members) (Component B)
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Component A: The percentage to be used for Component A shall be an equal percentage derived by dividing 100 by the number of market participants in the "N-second group."

Component B: Size Pro-rata Allocation: The percentage to be used for Component B of the Allocation Algorithm formula is that percentage that each participant of the "N-second group's" quote at the best price represents relative to the total number of contracts of all market participants of the "N-second group."¹⁴

Final Weighting: The final weighting, which shall be determined by the appropriate FPC, shall be a weighted average of the percentages derived for Components A and B, multiplied by the size of the order(s) in the electronic book. Initially, the weighting of components A and B shall be equal, represented mathematically by the formula: ((Component A Percentage + Component B Percentage)/2) * electronic book order size.

If a DPM is eligible for an allocation by virtue of being a member of the "N-second group" as described in paragraph (C)(2) above, the DPM shall 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). 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.

The Exchange believes this process whereby all members of the "N-second group" receive an allocation of orders in the book will enhance competition. As discussed above, this process only applies when market participants attempt to access orders resting in the electronic book (*i.e.*, liquidity-taking). As such, this process has no effect on a market participant's liquidity-providing activities where he receives allocation of incoming orders. Thus, market makers

will always have an incentive to quote competitively (provide liquidity). Second, this process ensures that the market-making organization with the deepest pockets and fastest technology does not monopolize every order in the electronic book. This "arms race" scenario would create a situation where the fastest machine wins every time, even if it was faster by a number as miniscule as a few milliseconds.¹⁵ This in turn would create a disincentive to other market participants who would be unable to interact with orders in the book. Creation of an "N-second group," conversely, gives these market participants an incentive to continue to submit orders and hence more of an incentive to remain on the floor of the exchange making markets, providing crucial liquidity.

D. Quotes Interacting With Quotes (Proposed Rule 6.45A(d))

Because Hybrid allows the simultaneous entry of quotes by multiple market makers,¹⁶ there may be instances where quotes may become locked. If an in-crowd market maker's (including the DPM) disseminated quote interacts with the disseminated quote(s) of another in-crowd market maker (including the DPM), resulting in the dissemination of a "locked" quote (*e.g.*, \$1.00 bid "1.00 offer"), the following shall occur:

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

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

(C) A "counting period" will begin during which market makers whose quotes are locked may eliminate the locked market. Provided, however, that in accordance with subparagraph (A) above a market maker will be obligated to execute customer and broker-dealer orders eligible for automatic execution pursuant to CBOE Rule 6.13 at his

disseminated quote in accordance with CBOE Rule 8.51. During the "counting period" market makers will 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 period the quotes remain locked, the locked quotes will automatically execute against each other in accordance with the allocation algorithm described above in CBOE Rule 6.45A(a).

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

The Exchange notes that the Hybrid System will not disseminate an internally crossed market (*i.e.*, the CBOE Bid is higher than the CBOE offer—\$1.10 bid × \$1.00 offer). If a market maker submits an incoming quote that would cross an existing quote, the Exchange will alter the incoming such that it locks the existing quote, at which point the locked quotes will be treated in accordance with the procedures described above. Correspondingly, the Exchange will notify the second market maker that its quote has been changed.¹⁷

The Exchange adds new Interpretations .01 and .02 to clarify that order entry firms may not bypass the crossing (CBOE Rule 6.74) and solicitation (CBOE Rule 6.9) rules without exposing orders they represent as agent for at least 30 seconds prior to electronically executing against those

¹⁴ As noted in Rule 6.45A(c)(ii), the appropriate FPC may determine that the maximum quote size to be used for each market participant in the Component B calculation shall be no greater than the cumulative size of orders resident in the electronic book at the best price at which market participants are attempting to buy (sell). This would prevent a market participant from "sizing out" competing market participants by, for example, submitting an order for 1,000 contracts to buy a book order for 10 contracts.

¹⁵ The Exchange notes that customers or anyone else eligible to submit orders electronically may access the book ahead of market participants. In this instance, customers would have absolute priority and would not be required to share the order allocation with members of the N-second group.

¹⁶ At the Exchange's request, the term "market participant" has been replaced with the term "market maker" throughout the discussion of proposed CBOE Rule 6.45A(d). Telephone conversation between Stephen Youhn, Senior Attorney, CBOE and Deborah Flynn, Assistant Director, Division of Market Regulation, Commission, on April 7, 2003.

¹⁷ During the lock period, if the existing quote is cancelled subsequent to the changing of the incoming quote, the incoming quote will 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 will be changed to 1.20–1.40 and the disseminated quote will 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) will revert to its original value of 1.25–1.40.