

would be required to provide two-sided quotations that meet certain quote spread parameters through an auto-quoting device when present in the trading crowd. FMMs would also be obligated to vocalize a two-sided legal-width market whenever a floor broker enters the trading crowd.

Finally, when present in the trading crowd, SMMs would be required to provide the size of their quotations at the LMM's bid or offer through an electronic interface device. Also, like FMMs, SMMs would be obligated to vocalize a two-sided, legal-width market whenever a floor broker enters the trading crowd.

In addition, all Market Makers must trade at least 75% of their average daily trading volume per quarter in issues included in their primary appointment.<sup>41</sup> All Market Makers, except RMMs, must also execute at least 60% of their transactions in-person.

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 of the Board of Governors of the Federal Reserve system 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.<sup>42</sup> The Commission believes that a 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 PCX's rules impose such affirmative obligations on PCX Plus Market Makers.

## B. Priority and Allocation

Under the proposal, the best priced bids and offers have priority over worse priced bids and offers. The Commission believes that the capability that PCX Plus provides to market makers to independently submit their quotes and then reward market makers with better quotes through this priority rule should substantially enhance incentives to quote competitively by providing market participants that improve the quote with an allocation of the resulting trade.<sup>43</sup>

In addition, bids and offers for public customers would get first priority over other bids or offers at the same price. If there is more than one highest bid or lowest offer for a public customer, the bids/offers would be ranked based on time priority. Non-customer orders and Quotes with Size would be allocated (after any LMM or FIQ guarantees, discussed below) on a size pro rata basis.

### 1. LMM Guarantee

PCX Rule 6.82 currently provides LMMs with a 40% participation right in transactions occurring at their disseminated bids and/or offers in their allocated issues. PCX Plus rules would also guarantee to the LMM 40% of the portion of an order traded at the LMM's quote that remains after the execution of all public customer orders and quotes with FIQ status. The LMM, however, would be entitled to its size pro rata allocation, if it were greater than the allocation it would receive under the LMM guarantee. In no event would the LMM be allocated contracts greater than its disseminated size.<sup>44</sup>

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 lead 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.<sup>45</sup> 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.<sup>46</sup>

Instituting Public Administrative Proceedings Pursuant to section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, which required the PCX (as well as other floor-based option market exchanges) to adopt new, or amend existing rules to substantially enhance incentives to quote competitively and substantially reduce disincentives to act competitively. See Settlement Order, *supra* note 34.

<sup>44</sup> Proposed PCX Rule 6.76(a)(2)(C)(iii).

<sup>45</sup> 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 Phlx to establish an 80% specialist guarantee would be consistent with the Act).

<sup>46</sup> See, e.g., Securities Exchange Act Release No. 45936 (May 15, 2002), 67 FR 36279, 26280 (May 23, 2002) (SR-CBOE–2002–10) (approving participation entitlements that range from 34 percent to 40 percent for the DPM providing the primary quote feed, depending on the total number of appointed market makers in the option); Securities Exchange Act Release No. 42835 (May 26, 2000), 65 FR 35683,

### 2. FIQ Status

A non-customer order or Quote with Size that improves the best bid or offer on the Exchange will have FIQ status with respect to other bids or offers at the same price, unless it is matched or further improved within three seconds. An order or Quote with Size with FIQ status is entitled to trade against the greater of: (1) 40% of the next inbound electronic order or orders (after public customer orders have been executed), and (2) the total size that the order or Quote with Size with FIQ status would be entitled to receive pursuant to a size pro rata allocation. An order or Quote with Size with FIQ status would not be awarded a greater number of contracts than the size of the bid or offer with FIQ status. LLMs would be entitled only to the greater of their 40% guaranteed participation or the number of contracts the LMM would be entitled to receive for having FIQ status.<sup>47</sup>

The Phlx commented that because the "LMM need only match the price improving quote (as opposed to further improving it), LMMs likely would automate the matching process to ensure that no Market Maker that improves the quote would ever be able to maintain FIQ status."<sup>48</sup> The Commission, however, does not believe that giving any preference to a Market Maker that first improves the quote is required by the Act. The Commission also believes that because all PCX Plus Market Makers will be able to independently and automatically generate quotes in all series and will participate in the trade pursuant to the size pro rata allocation when they are at the best price, that even if the Market Maker loses its FIQ status because its quote is matched by another Market Maker or the LMM, the proposal substantially enhances incentives to quote competitively.<sup>49</sup> Finally, although it is not unlawful for a market maker to take the prices offered by its competitors into account when setting its own prices, or to follow or copy prices of its

35685–66 (June 5, 2000) (SR-CBOE–99–10) (approving DPM guarantee for crossed orders that, when combined with the percentage crossed by the floor broker, cannot exceed 40% of the original order (after relevant public customer orders have been satisfied)); and Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11398 (March 2, 2000) (approving International Securities Exchange's application for registration as a national securities exchange, which contains a 40% participation right for facilitating EAMs); see also Phlx 80/20 Proposal, *supra* note 45.

<sup>47</sup> See proposed PCX Rule 6.76(a)(3)(C).

<sup>48</sup> See Phlx Letter, *supra* note 6.

<sup>49</sup> Currently, a Market Maker that improves the quote would be able to participate in the resulting trade only if that Market Maker happens to be next on the Auto-Ex "wheel."

<sup>41</sup> PCX represents that this 75% average daily trading volume requirement will apply to all PCX Market Makers pursuant to PCX Rule 6.35, Commentary .03. Telephone conversation between Kathryn Beck, Senior Vice President, General Counsel, and Corporate Secretary, PCX, and Sapna C. Patel, Attorney, Division, Commission, on April 10, 2003.

<sup>42</sup> See 12 CFR 221.5(c)(6).

<sup>43</sup> The Exchange has submitted the proposed rule change pursuant to subparagraph IV.B.h.(i)(aa) of the Commission's September 11, 2000 Order