

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 CBOE included statements concerning the purpose of and basis for its proposal and discussed any comments it had received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in sections A, B and C below, of the most significant aspects of such statements.

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

1. Purpose

Effective August 1, 2001, the CBOE suspended its \$.40 per contract marketing fee that was used by the appropriate DPM to attract order flow to the CBOE.⁴ The CBOE previously had established its marketing fee effective as of July 1, 2000.⁵ At the time the CBOE suspended the assessment of the marketing fee, it expressly noted that it reserved the right to reinstate the marketing fee at a future date if it deemed appropriate, and that it might establish a pre-contract fee different from the former \$.40 per contract marketing fee. At the time the CBOE suspended its marketing fee, both the American Stock Exchange and the Philadelphia Stock Exchange also suspended their marketing fee programs. Two other options exchanges (the Pacific Exchange and the International Securities Exchange) continued to impose a marketing fee program for the purpose of attracting order flow to those exchanges. The Philadelphia Stock Exchange has since reinstated its marketing fee program. The CBOE believes that these programs operate to the competitive disadvantage of the CBOE.

The CBOE states that it has determined to reinstate its marketing fee program in a modified form, effective June 1, 2003. The fee will be imposed at a rate of \$.40 per contract on market-maker transactions, including those of DPMs, in all classes of options in which a DPM has been appointed as described below. According to the CBOE, this program, like the CBOE's prior marketing fee program, provides for the

equitable allocation of a reasonable fee among the CBOE members and is designed to enable the CBOE to compete with other markets in attracting options order flow in multiply traded options from firms that include payment as a factor in their order routing decisions in designated classes of options. However, the CBOE has slightly modified its marketing fee program with the goal of imposing the fee only with respect to those market-maker transactions involving customer orders from firms that accept payment for their orders. Accordingly, the marketing fee will be assessed only on market-maker transactions involving customers of firms that accept payment pursuant to agreements with DPMs.

The CBOE states that it will not have any role with respect to the negotiations between DPMs and payment accepting firms. Rather, the CBOE proposes to pass through to market-makers and DPMs the fee to be collected. In those classes for which a DPM has advised the CBOE that it has negotiated with a payment accepting firm to pay for that firm's order flow, the CBOE will provide administrative support for the program. Specifically, the CBOE asserts that it will keep track of the number of qualified orders each payment accepting firm directs to the CBOE, and make the necessary debits and credits to the accounts of the DPMs, market-makers, and the payment accepting firms to reflect the payments that are to be made. The CBOE represents that all of the funds generated by the fee will be used only to pay the firms for the order flow sent to the CBOE.

The CBOE believes that \$.40 per contract is an equitable allocation of a reasonable fee among CBOE members. The CBOE states that it has designed this program to enable it to compete with other markets in attracting options order flow in multiply traded options. If a DPM advises the CBOE that it has negotiated a lower amount, the CBOE will refund to market-makers and DPMs the excess fee collected.

The CBOE states that the marketing fee will be assessed only on transactions of market-makers (including DPMs) resulting from orders for 200 contracts or less from customers of payment accepting firms. In the CBOE's view, because the marketing fee will be passed through only to those market-makers' transactions resulting from orders from customers of a payment accepting firm that the DPM has independently negotiated with to pay for that firm's order flow, there will be a direct and fair correlation between those members who pay the costs of the marketing program

funded by the fee and those who receive the benefits of the program.

The CBOE represents that after the marketing fee has been in effect for three months, the members of a particular trading crowd may determine not to participate in this marketing fee program pursuant to the procedures that the CBOE is proposing in a new Interpretation .12 to CBOE Rule 8.7. These procedures are described in a separate proposed rule change, SR-CBOE-2003-20, that the CBOE has filed with the Commission.⁶ The CBOE is proposing to institute these procedures as a pilot program, which is to expire one year after the Commission approval.

According to the CBOE, it is important to note that although market-maker transactions resulting from customer orders from firms that do not accept payment for their orders are not subject to the fee, CBOE market-makers will have no way of identifying prior to execution whether a particular order is from a payment-accepting firm, or from a firm that does not accept payment for their order flow.

In connection with any program involving payment for order flow that may be funded by the CBOE's proposed marketing fee, the CBOE will issue appropriate regulatory or educational circulars to its members that emphasize the disclosure and best execution obligations of members who may accept such payment.

2. Statutory Basis

The CBOE believes that because this marketing fee will serve to enhance the competitiveness of the CBOE and its members, this proposal is consistent with and furthers the objectives of the Act, including specifically section 6(b)(5) thereof,⁷ which requires the rules of exchanges to be designed to remove impediments to and perfect the mechanism of a free and open market and a national market system, and section 11A(a)(1) thereof,⁸ which reflects the finding of Congress that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure fair competition among brokers and dealers and among exchange markets. The CBOE also believes that the proposed rule change

⁶ Contemporaneous with the filing of this proposed rule change, CBOE filed SR-CBOE-2003-20, which sets forth the procedures by which a trading crowd may manifest its intention that it does not want to participate in the CBOE's marketing fee program. The CBOE has requested accelerated approval of this proposed rule change as a pilot program.

⁷ 15 U.S.C. 78f(b)(5).

⁸ 15 U.S.C. 78k-1.

⁴ See Exchange Act Release No. 44717 (August 16, 2001), 66 FR 44655 (August 24, 2001), (SR-CBOE-2001-43).

⁵ See Exchange Act Release No. 43112 (August 3, 2000), 65 FR 49040 (August 10, 2000), (SR-CBOE-00-28).