

“Hybrid System”), an options trading platform that would combine the features of electronic and open outcry, auction market principles, while, at the same time, providing market makers the ability to electronically stream their own quotes. Today, CBOE’s disseminated quote represents, for the most part, only the DPM’s automatically generated quotations. Market makers are able to affect changes to that quote only in open outcry (or by putting up manual quotes). Hybrid would offer in-crowd market makers and in-crowd DPMs⁹ the opportunity to submit their own firm disseminated market quotes that represent their own trading interest.¹⁰ In addition, in-crowd floor brokers would be permitted to enter orders on behalf of their customers for display in the CBOE’s best bid or offer (“BBO”). Market makers would have the ability to stream quotes that reflect their individual trading interest.

Incoming electronic orders from public customers and non-market maker broker-dealers that automatically execute against market participants’ quotes would be allocated to the best quoters pursuant to a new trading algorithm. This “Ultimate Matching Algorithm” (“UMA” or the “allocation algorithm”) retains public customer priority and rewards market participants for quoting at the best price and for providing liquidity at the best price.

Hybrid also retains features of a floor-based, open outcry exchange. Order entry firms would continue to have the option of sending floor brokers into a trading crowd to request markets on behalf of their customers. Trading crowds, as is the case today, would continue to have the opportunity to offer price improvement to orders that are exposed to the open outcry, auction market environment.

Under Hybrid, non-market maker broker-dealers would have the same access to the automatic execution feature of Hybrid as public customers.¹¹ In this regard, non-market maker broker-dealers orders would be permitted to automatically execute against quotes and resting limit orders on the book, whether those orders are public customer orders or broker-dealer orders. Additionally, at the discretion of the

Floor Procedure Committee (“FPC”), broker-dealer orders would be eligible for placement into the electronic book, where they may be executed electronically.¹²

To implement Hybrid, the Exchange proposes to adopt several new rules (most notably, CBOE Rules 6.13 and 6.45A) and to amend several existing rules. New CBOE Rule 6.13 would replace the Exchange’s RAES Rule 6.8 for those classes in which Hybrid is operational and would govern the automatic execution of incoming electronic orders. Proposed CBOE Rule 6.45A would be the new priority and allocation rule and would codify UMA. A more complete description of the proposal is provided in Section IV, below.

This proposal would apply only to equity options. The Exchange proposes a rollout schedule to begin trading of equity option classes on Hybrid by May 30, 2003. New equity option classes would continue to be rolled out gradually as the Exchange and its membership become more familiar with the operation of the system. The determination of which classes to roll out, and when to roll them out, would be made by the Equity FPC. The Exchange plans to expand the rollout to the Top 200 classes by January 2004 and, by the fourth quarter of 2004, to expand the rollout to the 500 most active equity options. The Exchange intends to implement Hybrid floor-wide in all classes by the fourth quarter of 2006.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 5 and 6 to the proposed rule change, including whether Amendments No. 5 and 6 are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, would be available for inspection and copying in the Commission’s Public Reference Room. Copies of such filing would also

be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR–CBOE–2002–05 and should be submitted by June 30, 2003.

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a national securities exchange and, in particular, with the requirements of section 6(b) of the Act.¹³ Specifically, the Commission finds that approval of the proposed rule change, as amended, is consistent with section 6(b)(5) of the Act¹⁴ in that it is designed to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and in general, to protect investors and the public interest.

A. Automatic Executions

CBOE Hybrid would permit the automatic execution of incoming electronic customer and non-market maker broker-dealer orders in classes designated for trading on Hybrid. Pursuant to proposed CBOE Rule 6.13(b)(i)(C), two categories of orders would be eligible, for the same number of contracts, for automatic execution: orders from non-broker-dealer public customers and orders from non-market maker broker-dealers. The appropriate FPC would be permitted to determine that orders from market makers and specialists would also be eligible for automatic execution.¹⁵ Orders not eligible for automatic execution instead would route to PAR, BART, or, at the order entry firm’s discretion, to the order entry firm’s booth printer.¹⁶

¹³ 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁴ 15 U.S.C. 78f(b)(5).

¹⁵ CBOE market makers who are physically present in the trading crowd would be permitted to submit one-sided quotes (also referred to as an order) or two-sided quotes. See Amendment No. 6, *supra* note 7.

¹⁶ BART is the Booth Automated Routing Terminal that enables firms to maintain orders in electronic format. Orders routed to the firm’s booth, as opposed to BART, would print at the booth and must be handled by the firm manually. As is the case today, the FPC would have the discretion, on a class by class basis, to route orders to PAR or

⁹ See Amendment No. 6, *supra* note 7.

¹⁰ In-crowd floor brokers may represent orders on behalf of members, broker-dealers, public customers, and the firm’s proprietary account. Pursuant to CBOE 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 would be one to buy or sell. Unlike market makers and the DPM, floor brokers may not stream quotes.

¹¹ See proposed CBOE Rule 6.13(b)(i)(B)(1).

¹² See proposed CBOE Rule 7.4(a).