

for Component B is that percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote. The final relative weighting of Components A and B would be determined by the appropriate FPC,²⁹ but initially, would be equal. The assigned weightings of Components A and B would be multiplied by the percentages derived for Components A and B, respectively, and then would be multiplied by the size of the incoming order.

In its comment letter, the ISE argues that the proposal "will allow an FPC to change the allocation algorithm in many different ways * * *" and that "[s]uch a broad range of allocation possibilities cannot be equally fair and equally provide the best incentives for competition."³⁰ In response to ISE's comment, the CBOE represents that changes to these weightings would be made very infrequently and would apply floorwide in all classes within that FPC's jurisdiction.³¹ The CBOE further notes that the proposal requires that changes to these weightings must be announced to Exchange members in advance of implementation. Thus, the CBOE concludes that there is no possibility of "gaming" the formulas to disproportionately benefit certain trading crowds.

As stated above, the proposed allocation algorithm consists of the weighting of two components: the parity component, which treats as equal all market participants quoting at the relevant best bid or best offer, and the size pro-rata component, which provides greater allocations to market participants with larger quotes. The Commission must consider whether each component and all possible combinations of each component are consistent with the Act. The Commission has previously approved allocation algorithms that provide an equal allocation to participants quoting at the best price, as well as algorithms that provide for size pro rata allocations.³² The Commission also believes that any combination of these two algorithms would be consistent with the Act. In addition, the Commission believes that the proposed Hybrid System, including the proposed allocation algorithm, should substantially enhance incentives to quote competitively by providing market participants with the ability to

independently submit their quotes and then rewarding market participants that quote at the best price with an allocation of the resulting trade.³³

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 competitors, such a decision must be a unilateral business judgment not intended to harass or punish a competitor for improving prices or otherwise acting competitively and not the result of collusive agreement. Accordingly, the Commission expects that the CBOE will surveil its market to ensure that market makers are not coordinating quotes in the Hybrid System or engaging in other anticompetitive conduct.

2. Allocation of Orders Represented in the Trading Crowd by Floor Brokers

Orders represented in the trading crowd would first be executed against public customer orders in the electronic book. Multiple public customer orders in the electronic book at the same price would be ranked based on time priority.³⁴

After public customer orders on the book at the best price are exhausted, the method for allocating the remainder of orders that are represented in the trading crowd by floor brokers would depend upon whether there were any book market participants ("BMP")³⁵ quoting at the prevailing price. If there were no BMP present at the prevailing price, open outcry orders would be allocated pursuant to existing CBOE Rule 6.45(a) and (b). If there were a BMP quoting at the prevailing price, open outcry orders would be allocated as follows: If two or more bids (offers) represent the best price, priority would continue to be afforded in the sequence in which the bids (offers) were made, subject to the restriction that the first market participant to verbally respond would be entitled to 70% of the order.

³³ The Exchange has submitted the proposed rule change pursuant to subparagraph IV.B.h.(i)(aa) of the Commission's September 11, 2000 Order 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 CBOE (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.

³⁴ See proposed CBOE Rule 6.45A(b)(i)(A).

³⁵ If, pursuant to CBOE Rule 7.4(a), the appropriate FPC determines to allow broker-dealer orders to be placed in the electronic book, then, for purposes of proposed CBOE Rule 6.45A(b), the cumulative number of broker-dealer orders in the electronic book at the best price would be deemed one BMP, regardless of the number of broker-dealer orders in the book.

The second market participant to verbally respond (if ascertainable) would be entitled to 70% of the remainder of the order (*i.e.*, 70% of 30%). The balance of the order would be apportioned equally among the remaining market participants verbally bidding (offering) at the same price and the BMP. The portion allocated to the BMP would be distributed among each book market participant pursuant to the UMA.

If, at any point, the sequence in which market participants verbally respond is not ascertainable, any remaining balance of an incoming order would be apportioned equally among the remaining market participants bidding (offering) at the same price and, if applicable, the BMP. If a market participant declines to accept any portion of the available contracts, any remaining contracts would be apportioned equally among the other participants who bid (offered) at the best price (including the book market participant, if applicable) at the time the market was established, until all contracts have been apportioned.

The Commission believes that the proposed rules governing allocation of orders represented in the trading crowd are consistent with the Act.

3. Interaction of Market Participant's Quotes/Orders with Orders in the Book

Under proposed CBOE Rule 6.45A(c), market participants would be permitted to submit orders or quotes electronically to trade with orders in the electronic book. However, for purposes of proposed CBOE Rule 6.45A(c), a floor broker market participant would be permitted only to represent as agent customer orders.³⁶ When a market participant's quote or order interacts with the order in the book, a trade occurs, and CBOE would disseminate a last sale report, and the size of the order would be decremented to reflect the execution.³⁷ If only one market participant submits an electronic order or quote to trade with an order in the electronic book, that market participant would be entitled to receive an allocation of that order in the electronic book up to the size of the market participant's quote or order. If, however, more than one market participant submits a quote or order to trade with the book within a period of time not to exceed 5-seconds³⁸ of the first market

³⁶ See Amendment No. 6, *supra* note 7.

³⁷ *Id.*

³⁸ This N-second period is configurable by the appropriate FPC but would never exceed 5-seconds. Any reduction of this N-second period (or subsequent increase) would be announced to the membership in advance of implementation via

²⁹ See CBOE Response Letter, *supra* note 8.

³⁰ See ISE Letter, *supra* note 5.

³¹ See CBOE Response Letter, *supra* note 8.

³² See PCX Rule 6.75(c); CBOE Rule 6.45(a)(ii)(2); and PCX Rule 6.76(a)(4).