

period, the quotes remain locked, the locked quotes would automatically execute against each other in accordance with the allocation algorithm described above in proposed CBOE Rule 6.45A(a).

The Hybrid System would not disseminate an internally crossed market (*i.e.*, the CBOE bid is higher than the CBOE offer). If a market maker were to submit an incoming quote that would cross an existing quote, the Exchange would automatically alter the incoming quote such that it locks the existing quote, at which point the locked quotes would be treated in accordance with the procedures described above. The Exchange would notify the second market maker that its quote has been changed.⁵⁰ The Commission believes that the proposed provisions are consistent with the Quote Rule. Market makers would continue to be required to honor their quotes and, thus, would be obligated to execute incoming orders pursuant to proposed CBOE Rule 6.13. The Commission notes that the market makers whose quotes are locked would continue to be obligated under the Quote Rule for at least one contract to each other during the counting period. At the end of the counting period, assuming neither market maker has changed its quotes, the market makers' quotes would execute against each other in all series.

PCX argues⁵¹ that these proposed rules are inconsistent with the Options Intermarket Linkage Plan ("Linkage Plan").⁵² The Commission notes that the Linkage Plan's admonition to avoid the dissemination of locked and crossed markets⁵³ would apply to CBOE Hybrid. The Commission believes that the proposed "counting period" provides a reasonable method for market makers that lock or cross a

market to unlock or uncross the market, as required by the Linkage Plan.⁵⁴ Importantly, during the "counting period," the market makers whose quotes are locked would remain obligated to execute customer and broker-dealer orders eligible for automatic execution at the locked price.⁵⁵

PCX also argues that the proposal would "exacerbate the occurrence of * * * non-disclosed crossed markets to the detriment of public investors."⁵⁶ The Linkage Plan requires the CBOE and the other options exchanges to avoid the dissemination of locked or crossed markets. If a market maker were to submit an incoming quote that would cross an existing quote, the Exchange proposed to automatically alter the incoming quote such that it locks the existing quote, thus avoiding the dissemination of a crossed market. The Commission believes the proposed rules regarding crossed markets provide a reasonable method of avoiding the dissemination of inverted markets.

5. DPM's Participation Entitlement

Under proposed CBOE Rule 6.45(a)(i)(C), if a DPM is eligible for an allocation pursuant to the operation of the UMA described above, the appropriate FPC would determine whether a DPM's allocation would be:⁵⁷

(A) the greater of 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)⁵⁸ or the amount it would otherwise receive pursuant to the operation of the proposed allocation algorithm described above; or

(B) 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).⁵⁹

In either case, the DPM's entitlement cannot exceed the size of the DPM's quote.

ISE expressed its concern that "the ability to * * * decide between alternative DPM entitlement formulas might be used to protect the DPM or maximize its participation based upon the level of competition it faces."⁶⁰ In response, the CBOE states that the Hybrid filing does not propose to change the level of the participation right guaranteed to DPMs and that changes to the DPM participation right are governed by CBOE Rule 8.87 and are subject to Board review. The Commission also notes that any changes to the DPM's participation rights must be filed with the Commission as a proposed rule change pursuant to Section 19(b) of the Act.

In addition, CBOE notes that the decision by the FPC regarding the allocation a DPM would receive under proposed CBOE Rule 6.45A(i)(C) would be in effect floorwide in all classes under the FPC's jurisdiction and would be announced to the membership in advance of implementation. CBOE believes this would preclude switching between the two allocation alternatives on a class basis based upon the level of competition faced by a DPM.

The Commission recognizes that a large guaranteed participation right would 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.⁶¹ 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.⁶² The

pursuant to CBOE Rule 8.87 (and Regulatory Circulars issued thereunder).

⁶⁰ See ISE Letter, *supra* note 5.

⁶¹ 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).

⁶² 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, 35685-66 (June 5, 2000) (SR-CBOE-99-10) (approving DPM guarantee for crossed orders that, when combined with the percentage crossed by the

⁵⁰ During the lock period, if the first quote is cancelled or changed, the second quote would 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 would be changed to 1.20-1.40 and the disseminated quote would 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) would revert to 1.25-1.40.

⁵¹ See PCX Letter, *supra* note 5.

⁵² See Securities Exchange Act Release Nos. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (order approving the Linkage Plan submitted by American Stock Exchange LLC, Chicago Board Options Exchange, Inc. and International Securities Exchange, Inc.); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000) (order approving the PCX as participant in Options Intermarket Linkage Plan); and 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000) (order approving Philadelphia Stock Exchange, Inc. as participant in the Linkage Plan).

⁵³ See Section 7(a)(i)(C) of the Linkage Plan.

⁵⁴ *Id.*

⁵⁵ See proposed CBOE Rule 6.45A(d).

⁵⁶ See PCX Letter, *supra* note 5.

⁵⁷ See proposed CBOE Rule 6.45A(a)(i)(C). Each pronouncement regarding which allocation alternative to be used would be made via Regulatory Circular.

⁵⁸ CBOE Rule 8.87 states that "[s]ubject to the review of the Board of Directors, the MTS Committee may establish from time to time a participation entitlement formula that is applicable to all DPMs." Any changes to this formula are required to be filed as a proposed rule change pursuant to Section 19(b) of the Act. Currently, a DPM's participation entitlement is 40% when there are two market makers at parity with the DPM and 30% when there are three or more market makers at parity with the DPM. See Securities Exchange Act Release No. 43750 (December 20, 2000), 65 FR 82420 (December 28, 2000) (SR-CBOE-00-52).

⁵⁹ Due to a systems limitation, the Exchange initially would use method two and set the DPM's allocation at the amount it would be entitled to