

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50058; File No. SR-CBOE-2004-48)

July 22, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Board Options Exchange, Incorporated Relating to Exchange Transaction Fees for DPMs and e-DPMs

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 20, 2004, the Chicago Board Options Exchange, Incorporated. (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to make a change to its Fee Schedule to maintain an equitable allocation of reasonable fees in the context of the CBOE’s new market structure initiatives.

The text of the proposed rule change is available at the Office of the Secretary, CBOE and at the Commission.

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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

In order to enhance competition and better service the needs of the investing community, the CBOE is continuing its efforts to provide an enhanced Hybrid market model of trading that combines the superior depth and liquidity of floor-based Market-Makers and Designated Primary Market-Makers ("DPMs") with the speed and convenience of electronic trading.

To that end, the CBOE has established an enhanced market model for equity options seeking to combine advanced technology with the broadest possible base of liquidity providers.<sup>3</sup> This new system is collectively referred to throughout this filing as "Hybrid 2.0." As further explained in this filing, a new category of market participants would function in Hybrid 2.0 as follows:

Electronic DPMs ("e-DPMs") would operate as competing specialists and be allowed to stream quotes into their appointed option classes without having to be physically present in the trading crowd. e-DPMs would be required to continuously stream quotes in a specified percentage of series of a broad number of option classes. They would have special eligibility requirements and would have to meet market performance standards.

In order to maintain an equitable allocation of Exchange costs and fees among the new category of market participants, as well as existing CBOE DPMs and Market-Makers,

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<sup>3</sup> See Securities Exchange Act Release No. 50003 (July 12, 2004), 69 FR 43028 (July 19, 2004) (approving File No. SR-CBOE-2004-24).

particularly in light of the additional costs the Exchange is incurring in providing new categories of electronic market access through Hybrid 2.0, the Exchange proposes several changes to the Exchange Fee Schedule.

#### Lower Fees and Alternative Fixed Fee Option for DPMs

The Exchange has already reduced the transaction fees of current DPMs in Hybrid 2.0 option classes by cutting the current DPM transaction fees to a total of \$.12 per contract.<sup>4</sup> The Exchange now proposes to offer current DPMs the opportunity to elect a fixed rate schedule (described in more detail below) instead of the current assessment of transaction fees on a per-contract basis. The alternative fixed rate schedule is also designed to reduce the DPMs' current fee obligations.

As the Exchange also noted in SR-CBOE-2004-38, there are several reasons why these reductions in DPM fees are both reasonable and equitable in this context. DPMs, in addition to being required to fulfill all the responsibilities of Market-Makers under CBOE Rule 8.7, are also responsible for fulfilling numerous additional responsibilities specified in CBOE Rule 8.85 that regular Market-Makers are not required to fulfill, most notably to provide continuous market quotations for each class and series allocated to the DPM.<sup>5</sup> Notwithstanding the substantial additional responsibilities of DPMs, CBOE DPMs have until recently paid the same transaction fees as those of CBOE Market-Makers. The Exchange respectfully submits that such equal fees in the past have been a product of Exchange policy, rather than a requirement of the Exchange Act or other applicable law. Due to the additional responsibilities borne by DPMs, the CBOE

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<sup>4</sup> See File No. SR-CBOE-2004-38.

<sup>5</sup> See CBOE Rule 8.85 "DPM Obligations," which sets forth numerous DPM obligations.

believes that it is reasonable and equitable under the Act for the CBOE to assess lower transaction fees to DPMs than to Market-Makers.

Again, as noted in SR-CBOE-2004-38, the Exchange believes it is particularly appropriate to re-examine DPM fees at the present time because the recent approval of some of the Exchange's Hybrid 2.0 market structure initiatives, as established in the approval of SR-CBOE-2004-24, is effectively reducing the compensation levels of DPMs. Specifically, DPMs have been compensated in part for their additional responsibilities through the participation entitlement formulas established pursuant to Exchange Rule 8.87. Under the Hybrid 2.0 market structure initiatives approved in SR-CBOE-2004-24, however, DPMs would now be required to share their previous participation entitlements with the new e-DPMs. The CBOE believed that it was therefore equitable to reduce DPM transaction fees from \$.24 per contract to \$.12 per contract to offset their reduced revenues from their reduced participation entitlement through lower transaction fees, as established in SR-CBOE-2004-38, and believes that it is also equitable to reduce DPM transaction fees by providing the alternative fixed fee arrangement proposed here.

#### Alternative Fixed Annual Fee

As part of its effort to reduce DPM transaction fees, the Exchange now proposes to offer DPMs, as well as e-DPMs, the alternative, as of October 1, 2004, to choose a fixed annual fee of \$1.75 million instead of the current assessment of transaction fees on a per-contract basis for its DPM and e-DPM transactions only<sup>6</sup> in all equity option classes.

Linkage fees and credits for CBOE DPMs electing the fixed annual fee would be treated as follows. Section 21 of the CBOE Fee Schedule (as established in SR-CBOE-2004-08)

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<sup>6</sup> The fixed fee does not cover any floor brokerage fees.

provides that the CBOE would credit back to DPMs all CBOE transaction fees that CBOE DPMs incur from outgoing Principal Acting as Agent (P/A) orders. DPMs electing to pay the fixed fee would neither be charged CBOE transaction fees for CBOE transactions related to such outgoing P/A orders, nor would they receive the above-mentioned corresponding credit back for such fees. However, pursuant to the second phase of linkage fee relief specified in SR-CBOE-2004-08, all CBOE DPMs, including those electing the fixed annual fee, who pay transaction fees at other exchanges to execute P/A orders there, would receive a credit of up to 50% of CBOE DPM transaction charges for each such order (or up to \$.06 per contract, with the total of such credits not to exceed the total amount of inbound linkage transaction fees received by the CBOE) to help offset the transaction fees of other exchanges that CBOE DPMs incur in filling P/A orders at those exchanges.

The Exchange would review the level of the fixed annual fee periodically as part of its annual budget process. As with all fee changes, any proposed changes to the fixed annual fee would be filed with the Commission.

#### e-DPM Fees

The Exchange proposes to set the transaction fee levels for e-DPMs at \$.22 per contract (the Market-Maker rate) through the end of July, and \$.25 per contract thereafter, in order to minimize the difficulties for the CBOE and its clearing members to process this fee change intra-month. The CBOE believes that the e-DPM transaction fee level is appropriately set higher than those of on-floor DPMs because the Exchange would incur additional systems and other logistical costs both initially and on an ongoing basis in order to establish and maintain the infrastructure needed to enable market participation as an e-DPM.

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As noted earlier, e-DPMs would have the option to elect the same fixed annual fee described above for regular DPMs, in recognition of the responsibilities that e-DPMs would shoulder in assisting the regular DPMs in their quoting responsibilities.<sup>7</sup>

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>8</sup> in general and furthers the objectives of Section 6(b)(4) of the Act<sup>9</sup> in particular, in that it is designed to provide for the equitable allocation of reasonable dues, fees, and other charges among CBOE members.

### B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing rule change establishes or changes a due, fee, or other charge imposed by the Exchange, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>10</sup> and subparagraph (f)(2) of Rule 19b-4 thereunder.<sup>11</sup>

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<sup>7</sup> The fixed fee would be one payment of \$1.75 million, even if the member organization holds appointments as both one or more regular DPMs and one or more e-DPMs.

<sup>8</sup> 15 U.S.C. 78f(b).

<sup>9</sup> 15 U.S.C. 78f(b)(4).

<sup>10</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>11</sup> 17 CFR 240.19b-4(f)(2).

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-48 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-48. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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, will be

available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2004-48 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>12</sup> 17 CFR 200.30-3(a)(12).