

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50732; File No. SR-CBOE-2004-71)

November 23, 2004

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Notice of Filing of Proposed Rule Change to Modify the Distribution of the DPM Participation Entitlement for Orders Specifying a Preferred DPM Under CBOE Rule 8.87

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 November 10, 2004, the Chicago Board Options Exchange, Inc. (“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 CBOE. 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 modify the distribution of the Designated Primary Market-Maker (“DPM”) participation entitlement for orders specifying a Preferred DPM under CBOE Rule 8.87. Below is the text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in brackets.

**Rule 8.87 Participation Entitlements of DPMs and e-DPMs**

- (a) No change.
- (b) The participation entitlement for DPMs and e-DPMs (as defined in Rule 8.92) shall operate as follows:
  - (1) Generally.

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

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

- (i) To be entitled to a participation entitlement, the DPM/e-DPM must be quoting at the best bid/offer on the Exchange.
  - (ii) A DPM/e-DPM may not be allocated a total quantity greater than the quantity that the DPM/e-DPM is quoting at the best bid/offer on the Exchange.
  - (iii) The participation entitlement is based on the number of contracts remaining after all public customer orders in the book at the best bid/offer on the Exchange have been satisfied.
- (2) Participation Rates applicable to DPM Complex. The collective DPM/e-DPM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the best bid/offer on the Exchange; 40% when there are two Market-Makers also quoting at the best bid/offer on the Exchange; and, 30% when there are three or more Market-Makers also quoting at the best bid/offer on the Exchange.
- (3) Allocation of Participation Entitlement Between DPMs and e-DPMs. The participation entitlement shall be as follows: If the DPM and one or more e-DPMs are quoting at the best bid/offer on the Exchange, the e-DPM participation entitlement shall be one-half (50%) of the total DPM/e-DPM entitlement and shall be divided equally by the number of e-DPMs quoting at the best bid/offer on the Exchange. The remaining half shall be allocated to the DPM. If the DPM is not quoting at the best bid/offer on the Exchange and one or more e-DPMs are quoting at the best bid/offer on the Exchange, then the e-DPMs shall be allocated the entire participation entitlement (divided equally between them). If no e-DPMs are quoting at the best bid/offer on the Exchange and the DPM is quoting at the best bid/offer on the Exchange, then the DPM shall be allocated the entire participation entitlement. If

only the DPM and/or e-DPMs are quoting at the best bid/offer on the Exchange (with no Market-Makers at that price), the participation entitlement shall not be applicable and the allocation procedures under Rule 6.45A shall apply.

(4) Allocation of Participation Entitlement Between DPMs and e-DPMs for Orders

Specifying a Preferred DPM. Notwithstanding the provisions of subparagraph (b)(3) above, the Exchange may allow, on a class-by-class basis, for the receipt of marketable orders, through the Exchange's Order Routing System when the Exchange's disseminated quote is the NBBO, that carry a designation from the member transmitting the order that specifies a DPM or e-DPM in that class as the "Preferred DPM" for that order.

In such cases and after the provisions of subparagraph (b)(1)(i) and (iii) above have been met, then the participation entitlement applicable to the DPM Complex (as set forth in subparagraph (b)(2) above) shall be allocated to the Preferred DPM subject to the following:

- (i) if the Preferred DPM is an e-DPM and the DPM is also quoting at the best bid/offer on the Exchange, then 1/3 of the participation entitlement shall be allocated to the DPM and the balance of the participation entitlement shall be allocated to the Preferred DPM;
- (ii) if the Preferred DPM is the DPM and one or more e-DPMs are also quoting at the best bid/offer on the Exchange, then 1/3 of the participation entitlement shall be allocated to the e-DPMs and the balance of the participation entitlement shall be allocated to the Preferred DPM;

- (iii) if the Preferred DPM is not quoting at the best bid/offer on the Exchange then the participation entitlement set forth in subparagraph (b)(3) above shall apply;
- (iv) if only members of the DPM Complex are quoting at the best bid/offer on the Exchange then the participation entitlement applicable to the Preferred DPM shall be: 50% when there is one other member of the DPM Complex also quoting at the best bid/offer on the Exchange; 40% when there are two other members of the DPM Complex quoting at the best bid/offer on the Exchange; and, 30% when there are three or more members of the DPM Complex also quoting at the best bid/offer on the Exchange. The other members of the DPM Complex shall not receive a participation entitlement and the allocation procedures under Rule 6.45A shall apply; and
- (v) in no case shall a DPM/e-DPM be allocated, pursuant to this participation right, a total quantity greater than the quantity that the DPM/e-DPM is quoting at the best bid/offer on the Exchange.

The Preferred DPM participation entitlement set forth in subparagraph (b)(4) of this Rule shall be in effect until [insert 1 year from SEC approval date] on a pilot basis.

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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 had received on the proposed rule change. 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.

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

1. Purpose

On July 12, 2004 the Commission approved a proposed rule change allowing competing remote electronic DPMs (“e-DPMs”).<sup>3</sup> Under these new rules, the Exchange may approve one or more e-DPMs for any option class trading on the CBOE’s Hybrid System. Among other things, e-DPMs are required to meet certain quoting obligations in at least 90% of the series of each allocated class,<sup>4</sup> and to promote the Exchange in a manner that is likely to enhance the ability of the Exchange to compete for order flow. The Exchange has approved seven e-DPMs to date. Option classes have been allocated to these e-DPMs in a manner that has resulted in no option class having more than four e-DPMs (in addition to a floor-based DPM).

As part of SR-CBOE-2004-24, the CBOE also amended CBOE Rule 8.87 relating to the participation entitlement of DPMs to account for e-DPMs.<sup>5</sup> More specifically, CBOE Rule 8.87 now provides that the DPM Complex (the DPM and e-DPM(s) combined) participation entitlement rate is 30% when there are three or more Market-Makers also quoting at the best price, 40% when there are two Market-Makers also quoting at the best price, and 50% when

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

<sup>4</sup> Alternatively, if a Request for Quote (“RFQ”) functionality is enabled for CBOE’s Hybrid System, e-DPMs could be required to respond to 98% of RFQs.

<sup>5</sup> DPMs and e-DPMs are only entitled to a guaranteed participation percentage if they are quoting at the best price on the Exchange. Further, the participation entitlement is based on the number of contracts remaining after public customer orders on the book have been filled.

there is one Market-Maker also quoting at the best price. The rule further details the manner in which the participation entitlement is divided between members of the DPM Complex. If the DPM and one or more e-DPMs are quoting at the best price, the collective e-DPM participation entitlement shall be one-half of the total entitlement and shall be divided equally by the number of e-DPMs quoting at the best price with the remaining half allocated to the DPM. If the DPM is not quoting at the best price and one or more e-DPMs are quoting at the best price, then the e-DPMs shall be allocated the entire participation entitlement (divided equally between them). If no e-DPMs are quoting at the best price and the DPM is quoting at the best price, then the DPM shall be allocated the entire participation entitlement. Lastly, if only the DPM and/or e-DPMs are quoting at the best price (with no Market-Makers at that price), the participation entitlement shall not be applicable and the allocation procedures under CBOE Rule 6.45A shall apply. The following example illustrates the application of the current participation entitlement for e-DPMs:

Example 1: Assume the CBOE market is 1 - 1.15 and both sides equal the NBBO. Also assume that the DPM and three e-DPMs are part of the \$1 bid along with ten Market-Makers and one customer order in the book for 10 contracts. A market order to sell 110 contracts will execute against the customer order in the book first for 10 contracts. After that, the participation right (which may or may not be used in the allocation of the order under CBOE Rule 6.45A) would be as follows: 15 contracts to the DPM and five contracts to each of the three e-DPMs.

The Exchange now seeks to modify the participation entitlement for orders designated with a Preferred DPM (the modified participation entitlement is being proposed as a one-year pilot program). Only a DPM or e-DPMs allocated a particular option class would be eligible for

the “preferred” designation in such class, and the Preferred DPM participation entitlement (described below) would only be granted if the Preferred DPM were quoting at the best price at the time the order is received and executed electronically by the Hybrid System. Thus, the preferred entitlement will only apply to orders executed at the NBBO. The proposed participation entitlement for the Preferred DPM is as follows:

- if the Preferred DPM is an e-DPM and the DPM is also quoting at the best bid/offer on the Exchange, then 1/3 of the participation entitlement shall be allocated to the DPM and the balance of the participation entitlement shall be allocated to the Preferred DPM;
- if the Preferred DPM is the DPM and one or more e-DPMs are also quoting at the best bid/offer on the Exchange, then 1/3 of the participation entitlement shall be allocated to the e-DPMs and the balance of the participation entitlement shall be allocated to the Preferred DPM;
- if the Preferred DPM is not quoting at the best bid/offer on the Exchange then the Preferred DPM participation entitlement shall not apply and the “regular” participation entitlement set forth in subparagraph (b)(3) of CBOE Rule 8.87 shall apply; and,
- if only members of the DPM Complex are quoting at the best bid/offer on the Exchange then the participation entitlement applicable to the Preferred DPM shall be: 50% when there is one other member of the DPM Complex also quoting at the best bid/offer on the Exchange; 40% when there are two other members of the DPM Complex quoting at the best bid/offer on the Exchange; and, 30% when

there are three or more members of the DPM Complex also quoting at the best bid/offer on the Exchange. All members of the DPM Complex other than the Preferred DPM will not receive a participation entitlement (but may participate on a trade pursuant to CBOE Rule 6.45A).

In no case shall a DPM/e-DPM be allocated a total quantity greater than the quantity that the DPM/e-DPM is quoting at the best bid/offer on the Exchange. Below are examples detailing how the proposed participation entitlement would operate:

Example 2: (with DPM as the Preferred DPM) - Assume the CBOE market is 1 - 1.15 and both sides equal the NBBO. Also assume that the DPM and two e-DPMs are part of the \$1 bid along with ten Market-Makers and one customer order in the book for 10 contracts. A market order designating the DPM as the Preferred DPM to sell 110 contracts will execute against the customer order in the book first for 10 contracts. After that, the participation entitlement (which may or may not be used in the allocation of the order under CBOE Rule 6.45A) would be as follows: 20 contracts to the DPM and five contracts to each of the two e-DPMs.

Example 3: (with e-DPM as the Preferred DPM) - Same market as Example 2 above. A market order designating e-DPM #1 as the Preferred DPM to sell 110 contracts will execute against the customer order in the book first for 10 contracts. After that, the participation entitlement (which may or may not be used in the allocation of the order under CBOE Rule 6.45A) would be as follows: 20 contracts to e-DPM #1, 10 contracts to the DPM, and no entitlement for e-DPM #2.



Example 4: (only members of the DPM Complex quoting at the best price) - Assume the CBOE market is 1 - 1.15 and both sides equal the NBBO. Also assume that the DPM and two e-DPMs are the only quoters on the \$1 bid. A market order designating e-DPM #1 as the Preferred DPM to sell 100 contracts is received. The participation entitlement (which may or may not be used in the allocation of the order under CBOE Rule 6.45A) would be as follows: 40 contracts to e-DPM #1. The balance of the order would be allocated to the DPM and e-DPM #2 pursuant to CBOE Rule 6.45A.

Example 5: (Preferred DPM not quoting at best price) - Assume the CBOE market is 1 - 1.15 and both sides equal the NBBO. Also assume that the DPM and three e-DPMs are part of the \$1 bid along with ten Market-Makers and one customer order in the book for 10 contracts. A market order designating e-DPM #4 (not part of \$1 bid) as the Preferred DPM to sell 110 contracts will execute against the customer order in the book first for 10 contracts. After that, the participation entitlement (which may or may not be used in the allocation of the order under CBOE Rule 6.45A) would be as follows: 15 contracts to the DPM and 5 contracts to each of the three e-DPMs. e-DPM #4 would not participate.

There would be no requirement that orders submitted to the Exchange carry a Preferred DPM designation. Further, by requiring DPMs to quote on the NBBO in order to receive a Preferred DPM participation entitlement, the Exchange believes that the proposed rule will significantly enhance quote competition and will result in greater liquidity for customers. Lastly, by providing e-DPMs with a greater participation right in cases where orders designate them as a Preferred DPM, the CBOE believes the proposal creates incentives for e-DPMs to competitively quote and to attempt to attract order-flow to the CBOE. This benefits the Exchange and its customers by adding liquidity to the CBOE's markets.

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,<sup>6</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>7</sup> in particular. By Rewarding DPMs and e-DPMs for making deep and tight markets and by enhancing their ability to compete for order flow, the Exchange believes the proposed rule change would: (i) promote just and equitable principles of trade; (ii) serve to remove impediments to and perfect the mechanism of a free and open market and a national market system; and (iii) help ensure that the Exchange can attract well capitalized firms as specialists which in turn serves to protect investors and the public interest.

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

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the CBOE consents, the Commission will:

- (A) by order approve such proposed rule change; or

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<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

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-2004-71 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-2004-71. 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 publicly available. All submissions should refer to File Number SR-CBOE-2004-71 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>8</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>8</sup> 17 CFR 200.30-3(a)(12).