

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51779; File No. SR-CBOE-2004-71)

June 2, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto to Modify the Distribution of the DPM Participation Entitlement for Orders Specifying a Preferred DPM under CBOE Rule 8.87

I. Introduction

On November 10, 2004, the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² to modify the distribution of the Designated Primary Market-Maker (“DPM”) participation entitlement for orders specifying a certain DPM or e-DPM (“Preferred DPM”) under CBOE Rule 8.87. The proposed rule change was published for comment in the Federal Register on December 1, 2004.³ The Commission received four comment letters on the proposal.⁴ On January 13, 2005, the CBOE sent a response to the comment letters.⁵

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 50732 (November 23, 2004), 69 FR 69967.

⁴ See letter from Michael J. Simon, General Counsel and Secretary, International Securities Exchange, Inc. (“ISE”), to Jonathan G. Katz, Secretary, Commission, dated December 31, 2004 (“ISE Letter”); letter from Michael J. Simon, General Counsel and Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, dated January 13, 2005 (“ISE Letter #2”); letter from Kenneth R. Leibler, Chairman, Boston Options Exchange Regulation (“BOXR”), to Jonathan G. Katz, Secretary, Commission, dated January 19, 2004 (sic) (“BOXR Letter”); and letter from Matthew Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C., on behalf of Citadel Derivatives Group LLC (“Citadel”), to Jonathan G. Katz, Secretary, Commission, dated April 6, 2005 (“Citadel Letter”).

⁵ See letter from Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, to Jonathan G. Katz, Secretary, Commission, dated January 13, 2004 (“CBOE Letter”).

On April 22, 2005, the CBOE filed Amendment No. 1 to the proposed rule change.⁶ This order approves the proposed rule change and simultaneously provides notice of filing and grants accelerated approval of Amendment No. 1.

II. Description of the Proposed Rule Change

The CBOE proposes to modify the participation entitlement for orders designated to a Preferred DPM on a one-year pilot basis. 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 would only be granted if the Preferred DPM were quoting at the National Best Bid or Offer (“NBBO”) at the time the order is received and executed electronically by the CBOE Hybrid System. In addition, the participation entitlement is based on the number of contracts remaining after public customer orders on the book have been filled.

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 NBBO, then 2/3 of the participation entitlement would be allocated to the Preferred DPM and the balance of the participation entitlement would be allocated to the DPM;
- If the Preferred DPM is an e-DPM, and the DPM is not quoting at the NBBO but one or more other e-DPMs are quoting at the NBBO, then 2/3 of the participation entitlement would be allocated to the Preferred DPM and the balance of the

⁶ Amendment No. 1 added language to the proposed rule text to clarify that if an e-DPM is the Preferred DPM for an order and the DPM is not quoting at the NBBO, any remainder of the participation entitlement that is not allocated to the Preferred DPM would be divided evenly among the remaining e-DPMs quoting at the NBBO.

participation entitlement would be divided equally between the other e-DPMs also quoting at the NBBO;⁷

- If the Preferred DPM is the DPM, and one or more e-DPMs are also quoting at the NBBO, then 2/3 of the participation entitlement would be allocated to the Preferred DPM and the balance of the participation entitlement would be divided equally between the e-DPMs quoting at the NBBO;
- If the Preferred DPM is not quoting at the NBBO, then the Preferred DPM participation entitlement would not apply and the “regular” participation entitlement set forth in subparagraph (b)(3) of CBOE Rule 8.87 would apply; and,
- If the DPM and e-DPMs (collectively “DPM Complex”) are the only CBOE members quoting at the NBBO then the participation entitlement applicable to the Preferred DPM would be: 50% when there is one other member of the DPM Complex also quoting at the NBBO; 40% when there are two other members of the DPM Complex quoting at the NBBO; and, 30% when there are three or more members of the DPM Complex also quoting at the best bid/offer on the Exchange. No other members of the DPM Complex other than the Preferred DPM will receive a participation entitlement, but may participate on a trade pursuant to CBOE Rule 6.45A.

In no case would a DPM or e-DPM be allocated a total number of contracts greater than the number of contracts that the DPM or e-DPM is quoting.

⁷ This paragraph was added to the proposed rule change pursuant to Amendment No. 1.

III. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change, comment letters, and the CBOE's response and finds that the proposed rule change is consistent with the requirements of Section 6 of the Act⁸ and the rules and regulations thereunder applicable to a national securities exchange⁹ and, in particular, the requirements of Section 6(b)(5) of the Act.¹⁰ Section 6(b)(5) requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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.

The Commission received four comment letters regarding the proposal, all of which opposed the proposal.¹¹ The commenters criticized the proposal because they believe it would allow a DPM or e-DPM a guarantee based solely on its relationships with order entry firms rather than on such DPM's or e-DPM's obligations. The commenters assert that the proposal would reward a DPM or e-DPM for its payment for order flow arrangements rather than the quality of its quotes, and therefore the proposal would have a negative impact on price competition.¹² Two commenters also believed that the proposal did not address the possibility of coordinated actions between a DPM and an order entry firm.¹³

⁸ 15 U.S.C. 78f.

⁹ 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).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See supra note 4.

¹² See, e.g., ISE Letter, supra note 4, at 1-2; BOXR Letter, supra note 4, at 1-3; and Citadel Letter, supra note 4, at 2.

¹³ ISE Letter, supra note 4, at 5, and BOXR Letter, supra note 4, at 3.

The Commission has previously approved rules that guarantee CBOE DPMs and e-DPMs a proportion of each order when the DPM's or e-DPM's quote is equal to the NBBO.¹⁴ The Commission has closely scrutinized exchange rule proposals to adopt or amend a specialist guarantee where the percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange.¹⁵ Because the proposal would not increase the overall percentage of an order that is guaranteed to the DPM Complex, but instead would reallocate that guarantee, the Commission does not believe the proposal will negatively impact quote competition on the CBOE. Under the proposal, the remaining portion of each order will still be allocated based on the competitive bidding of market participants.

In addition, a Preferred DPM will have to be quoting at the NBBO at the time the order is received to capitalize on the guarantee. The Commission believes it is critical that the Preferred DPM cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received. In this regard, the CBOE's proposal prohibits an order flow provider from notifying a DPM or e-DPM regarding its intention to submit a Directed Order so that such DPM or e-DPM could change its quotation to match the NBBO immediately prior to submission of the preferenced order, and then fade its quote. In response to commenters' concerns that its proposal failed to protect against coordinated actions between a DPM and an order entry firm, CBOE stated that its rules already provide the necessary protections against that

¹⁴ See Securities Exchange Act Release No. 43004 (June 30, 2000) 65 FR 43060 (July 12, 2000) (SR-CBOE-98-54); see Securities Exchange Act Release No. 50003 (July 12, 2004), 69 FR 43028, (July 19, 2004) (SR-CBOE-2004-24).

¹⁵ See Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48788 (August 9, 2000).

type of conduct.¹⁶ Furthermore, the CBOE represents that it will proactively conduct surveillance for, and enforce against, such violations.¹⁷

One commenter states that DPMs and e-DPMs currently receive participation entitlements based on their obligations to the market.¹⁸ The commenter believes that the proposal, by allowing any directed market maker quoting at the NBBO to receive a guaranteed percentage of an order without in turn increasing such market maker's obligations to the market, would "eliminate the incentive to be a specialist, thereby potentially leaving the obligations of the specialist to the market unfulfilled."¹⁹ The Commission does not believe that the proposal will result in the role of the specialist going unfulfilled, and notes that it recently approved an options exchange without specialists.²⁰ Moreover, specialists' obligations to the market have been reduced through other changes, including greater automation of functions previously handled manually by the specialist. While this proposal may reduce the incentive to be a specialist, the Commission does not believe that makes the proposal inconsistent with the Act. Finally, the Commission notes that DPMs and e-DPMs have greater quoting obligations than other CBOE market makers who cannot be Preferred DPMs. Specifically, DPMs must provide

¹⁶ CBOE Letter, supra note 5, at 4 ("...CBOE Rule 4.18 expressly prohibits this sort of misuse of material, non-public information.").

¹⁷ See letter from Angelo Evangelou, Managing Senior Attorney, Legal Division, CBOE, to John Roeser, Assistant Director, Division of Market Regulation, Commission, dated May 27, 2005.

¹⁸ A DPM must maintain continuous quotes in every series of its assigned options classes. E-DPMs are required to continuously quote in 90% of series of each options class to which they are assigned. Market makers other than DPMs and e-DPMs are required to continuously quote only 60% of series to which they are assigned.

¹⁹ Citadel Letter, supra note 4, at 2.

²⁰ See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving trading rules for the Boston Options Exchange Facility).

continuous two-sided market quotations for each class and series allocated to it,²¹ and e-DPMs must provide continuous two-sided market quotations in at least 90% of the series of each class allocated to it.²² To receive an allocation under this rule filing, the Preferred DPM must be quoting at the NBBO for the size of the allocation received.

One commenter believes that the proposal is similar to facilitation guarantee programs and other directed order programs approved by the Commission.²³ However, unlike those programs, the commenter criticizes that the proposal does not include certain protections for customers, such as providing the opportunity for price improvement, or limiting the program to a minimum number of contracts.²⁴ This commenter did note, however, that the proposal would not “remove additional order flow from the auction in order to ‘reward’ the preferred DPM. Rather, it is reallocating the specialist allocation among the DPMs when a member preferences one DPM.”²⁵

The Commission believes that the proposal is more akin to current participation entitlements, for DPMs and eDPMs, than the facilitation guarantee programs and other directed order programs cited by the commenter. As CBOE notes, unlike other programs, the Preferred DPM would not have an opportunity to “preview” an order to decide whether or not to trade with it.²⁶ Moreover, unlike exchange facilitation guarantee programs,²⁷ under the proposal, the

²¹ See CBOE Rule 8.85(a)(i).

²² See CBOE Rule 8.93(i).

²³ ISE Letter, supra note 4, at 4.

²⁴ Id. at 1-2.

²⁵ Id. at 4.

²⁶ CBOE Letter, supra note 5, at 2.

²⁷ See CBOE Rule 6.74(d); ISE Rule 716(d); Pacific Exchange, Inc. Rule 6.47(b); American Stock Exchange, Inc. Rule 950(d), Commentary .02(d); and Philadelphia Stock Exchange, Inc. Rule 1064, Commentary .02.

preferred DPM would not be eligible for a participation entitlement unless it is publicly quoting at the NBBO at the time an order is received. Instead of changing its facilitation program rules, this proposal reallocates the current participation entitlement available for DPMs and eDPMs. The Commission believes this reallocation is consistent with the Act and will not affect the incentives of the trading crowd to compete aggressively for orders based on price.

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution of customer orders, and any decision to preference a particular DPM or e-DPM must be consistent with this duty.²⁸ A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.²⁹

²⁸ See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (January 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

²⁹ Order Handling Rules Release, 61 FR at 48322. See also Newton, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See Newton, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); Marc N. Geman, Securities Exchange Act Release No. 43963 (February 14, 2001) (citing Newton, but concluding that respondent fulfilled his duty of best execution). See also Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See Newton, 135 F.3d at 273-274.

The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price.³⁰ The duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.³¹ Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.³² In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.³³

³⁰ Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. Id. at 270 n. 2 (citing Payment for Order Flow, Securities Exchange Act Release No. 33026 (October 6, 1993), 58 FR 52934, 52937-38 (October 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co. ("Manning"), Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008-55009.

³¹ Order Handling Rules Release, 61 FR at 48322-48333 ("In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security."). See also Newton, 135 F.3d at 271; Market 2000: An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) ("Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order."); Payment for Order Flow Final Rules, 59 FR at 55009.

³² Order Handling Rules, 61 FR at 48323.

³³ Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, "[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders." Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Exchange Act Rules 11Ac1-5 and 11Ac1-6 and noting that alternative

The Commission notes that the proposed rule change would be implemented on a pilot basis for one year. During this time, the Commission intends to evaluate the impact of the proposal on the options markets to determine whether it would be beneficial to customers and to the options markets as a whole before approving any request for permanent approval of the pilot program.

For these reasons, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,³⁴ and will not jeopardize market integrity or the incentive for market participants to post competitive quotes.³⁵

IV. Accelerated Approval of Amendment No. 1

Pursuant to Section 19(b)(2) of the Act,³⁶ the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendment No. 1 to the proposal, prior to the 30th day after publishing notice of Amendment No. 1 in the Federal Register.

The Commission believes that it has received and fully considered meaningful comments with respect to the proposal, and that Amendment No. 1 does not raise any new regulatory issues that warrant further delay. In Amendment No. 1, the CBOE added language to the proposed rule text to clarify that if an e-DPM is the Preferred DPM for an order and the DPM is not also

methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

³⁴ 15 U.S.C. 78f(b)(5).

³⁵ Approval of this proposal is in no way an endorsement of payment for order flow by the Commission.

³⁶ 15 U.S.C. 78s(b)(2).

quoting at the NBBO, the remainder of the participation entitlement that is not allocated to the Preferred DPM is divided evenly among the remaining e-DPMs on the Exchange quote. The Commission believes that the addition of the clarifying language is appropriate to provide for foreseeable scenarios regarding allocation of the participation entitlement for a Preferred DPM.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether Amendment No. 1 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. 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, Station Place, 100 F Street, NE, 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, 100 F Street, NE, 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].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁷ that the proposed rule change (SR-CBOE-2004-71) be, and hereby is, approved, and that Amendment No. 1 to the proposed rule change be, and hereby is, approved on an accelerated basis, for a pilot period to expire on June 2, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁸

Margaret H. McFarland
Deputy Secretary

³⁷ 15 U.S.C. 78s(b)(2).

³⁸ 17 CFR 200.30-3(a)(12).