

Number SR-CBOE-2004-22 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-2004-22. 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 Exchange. 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-2004-22 and should be submitted on or before May 18, 2004.

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

**J. Lynn Taylor,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49588; File No. SR-CBOE-2004-20]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Chicago Board Options Exchange, Inc., Relating to the \$5 Quotation Spread Pilot Program

April 21, 2004.

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 April 5, 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. On April 20, 2004, the CBOE filed Amendment No. 1 to the proposal.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

In January 2004, the CBOE implemented a six-month pilot program ("Pilot Program"), which expires on June 29, 2004, that permits quote spread parameters of up to \$5, regardless of the price of the bid, for up to 200 options classes traded on the CBOE's Hybrid Trading System ("Hybrid").<sup>4</sup> The CBOE subsequently expanded the Pilot Program to include all options classes traded on Hybrid.<sup>5</sup> The CBOE proposes to amend the Pilot Program to limit the applicability of the \$5 quote spreads permitted under the Pilot Program to quotations that are submitted electronically on the Hybrid system. The text of the proposed rule change appears below; additions are *italicized*.

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

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

<sup>3</sup> See letter from Steve Youhn, CBOE, to Nancy Sanow, Division of Market Regulation, Commission, dated April 19, 2004 ("Amendment No. 1"). Amendment No. 1 revises the text of the proposed rule to change a reference in CBOE Rule 8.7(b)(iv)(A) from "subparagraph (iv)(a)" to "subparagraph (iv)(A)."

<sup>4</sup> See Securities Exchange Act Release No. 49153 (January 29, 2004), 69 FR 5620 (February 5, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2003-50) ("Pilot Program Notice").

<sup>5</sup> See Securities Exchange Act Release No. 49318 (February 25, 2004), 69 FR 10085 (March 3, 2004) (notice of filing and immediate effectiveness of File No. SR-CBOE-2004-10) ("February 2004 Notice").

#### 8.7 Obligations of Market Makers

(a) No change.

(b)

(i)-(iii) No change.

(iv) To price options contracts fairly by, among other things, bidding and/or offering so as to create differences of no more than 0.25 between the bid and offer for each option contract for which the bid is less than \$2, no more than \$0.40 where the bid is at least \$2 but does not exceed \$5, no more than \$0.50 where the bid is more than \$5 but does not exceed \$10, no more than \$0.80 where the bid is more than \$10 but does not exceed \$20, and no more than \$1 where the bid is more than \$20, provided that the appropriate Market Performance Committee may establish differences other than the above for one or more options series. The bid/ask differentials stated above shall not apply to in-the-money series where the underlying securities market is wider than the differentials set forth above. For these series, the bid/ask differential may be as wide as the quotation on the primary market of the underlying security.

(A) For a six month period expiring on June 29, 2004, options on classes trading on the Hybrid system may be quoted *electronically* with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid. The \$5 quote widths shall only apply to classes trading on the Hybrid system and only following the opening rotation in each security (*i.e.*, the widths specified in paragraph (b)(iv) above shall apply during opening rotation). *Quotes given in open outcry in Hybrid classes may not be quoted with \$5 widths and instead must comply with the legal width requirements (e.g., no more than 0.25 between the bid and offer for each option contract for which the bid is less than \$2) described in paragraph (iv) and not subparagraph (iv)(A).*

Interpretations and Policies \* \* \*

No change.

#### 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 CBOE 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 in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the

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

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

The Pilot Program became effective in January 2004 and designated 200 options classes traded on Hybrid that, for a six-month pilot period, could be quoted with a difference not to exceed \$5 between the bid and the offer, regardless of the price of the bid.<sup>6</sup> In February 2004, the CBOE expanded the number of options classes included in the Pilot Program from 200 options classes traded on Hybrid to all options classes traded on Hybrid.<sup>7</sup>

The CBOE proposes to amend the Pilot Program to limit its application to electronic quoting only. Under the proposal, market makers would continue to be eligible to submit electronic quotes in Hybrid classes, provided that those quotes do not exceed \$5 between the bid and the ask price. In open outcry, however, market makers in those same classes would be required to give verbal quotes that comply with the current legal width requirements established in CBOE Rule 8.7(b)(iv).<sup>8</sup> This means that market makers would not be permitted to give verbal quotes in accordance with the terms of the Pilot Program.

The effect of the proposal would be to restrict the number of instances in which market makers would be permitted to provide quotes that exceed the current legal widths.<sup>9</sup> The CBOE notes that in open outcry, when a floor broker requests a market, a market maker has the ability to evaluate all pricing information publicly available prior to responding with a quote. Moreover, the CBOE notes that a market maker typically responds with one quote at a time, which substantially lessens the likelihood of multiple executions across different series. According to the CBOE, the ability to

<sup>6</sup> See Pilot Program Notice, *supra* note 4. The Pilot Program's relaxed quotation spread requirements apply after the opening trading rotation. During the opening trading rotation, market makers must quote in accordance with the traditional bid-ask width requirements. The \$5 quotation requirements permitted under the Pilot Program become operative immediately following the opening rotation.

<sup>7</sup> See February 2004 Notice, *supra* note 5.

<sup>8</sup> Under CBOE Rule 8.7(b)(iv), the allowable bid-ask differentials are: \$0.25 for options under \$2, \$0.40 for options between \$2 and \$5, \$0.50 for options between \$5 and \$10, \$0.80 for options between \$10 and \$20, and \$1.00 for options above \$20 ("current legal widths").

<sup>9</sup> See note 8, *supra*.

evaluate pricing information prior to giving a verbal quote is not a luxury that a market maker enjoys on the electronic side, where the market maker could execute numerous transactions before having the ability to adjust his or her quotes. For this reason, the CBOE believes that the need to be able to quote \$5 wide is lessened substantially in open outcry.

2. Statutory Basis

The CBOE believes that it is reasonable to limit the application of the Pilot Program to electronic quoting only. The CBOE believes that the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>10</sup> Specifically, the CBOE believes that the proposed rule change is consistent with the Section 6(b)(5)<sup>11</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, 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.

**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 Exchange consents, the Commission will:

(A) By order approve such proposed rule change, or

(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

<sup>10</sup> 15 U.S.C. 78f.

<sup>11</sup> 15 U.S.C. 78f(b)(5).

arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2004-20 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.

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**J. Lynn Taylor,**

*Assistant Secretary.*

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