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Regulatory Circular RG02-119

Date: December 23, 2002

To: Members and Member Firms

From: Trading Operations

RE: Education Program for Market Linkage

In October 1999, the Security and Exchange Commission (SEC) ordered the option exchanges to develop an option intermarket linkage plan to, among other things, limit trade-throughs and protect customer orders. In accordance with a schedule approved by the SEC, **the implementation of linkage will begin on January 31, 2003**. As required by the Linkage Plan, linkage will be implemented in two phases, which include the first phase beginning at the end of January 2003 and completing rollout by March 4, 2003, and the second phase starting on April 25, 2003 with a rollout completion in early June. CBOE's member education program will begin in early January and will continue through full implementation of phase 2.

Initially, the focus of the educational efforts will be related to the new concepts and functionality to the trading floor introduced by phase 1 of linkage. Details regarding Phase 2 will be outlined in a future circular. Listed below are the primary linkage concepts for phase 1:

- Certain Principal (P) and Principal-Acting-As-Agent (PA) orders are allowed in Phase 1. All P and PA orders are immediate or cancel (IOC) limit orders priced at the NBBO. P orders are sent by eligible market makers or DPMs. PA orders are sent by the DPM on behalf of an unexecuted customer order that is marketable against the away NBBO.
- Only P and PA orders that are autoex eligible will be allowed for Phase 1. More specifically:
  - P orders are restricted to a 10-contract maximum in Phase 1.
  - P orders are restricted to one per class, per each exchange per minute.
  - PA orders are restricted (in Phase 1) to the lesser of the sending and receiving exchange's autoex sizes at the time the order is sent. The CBOE autoex size is the lesser of the RAES size or the CBOE disseminated quote size.
- Outbound P and PA orders routed to away exchanges will receive autoex handling or be rejected.
- Inbound P and PA orders will route to RAES and ABP or be rejected back to the away exchange.
- All incoming linkage orders have a 10-contract minimum autoex size guarantee. If CBOE's disseminated quote size is less than 10, the RAES wheel will make up the difference, only for linkage trades.
- In support of the linkage "trade or fade" concept, an AutoFade mechanism will be introduced. Any time CBOE AutoQuote size is reduced to zero due to a trade, AutoFade will move the CBOE quote to one tick worse than the Best of the Rest NBBO price and disseminate with a default size. The AutoFade process will apply to all trading, not just linkage trades.
- Members should avoid initiating trade throughs of away exchanges.
- Members should avoid locking or crossing quotes of away exchanges. It is the obligation of the member who locked or crossed the away exchange to either send a P order to the away exchange, or he must change his quote to unlock or uncross the away exchange.
- Market Makers will access linkage through their clearing firm links to CBOE.
- Phase 2 linkage adds additional concepts, order types, regulations and functionality.

Exact training dates and times will be announced. Linkage questions can be directed to any subcommittee member listed below, Tim Watkins at 312-786-7172 or Dan Hustad at 312-786-7715.

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