

Regulatory Circular RG97-114

Date: September 5, 1997

To: Membership

From: Operations Planning Division

Re: Responsibilities and Obligations of Designated Primary Market Makers

The standards of competition that generally apply in CBOE's option market and that have been so critical to its success call for all bids and offers to be made in open outcry in an auction market governed by principles of price and time priority. Pursuant to Exchange Rule 6.43, these principles apply with equal force to trading crowds in which the Modified Trading System is utilized. In addition to the specific responsibilities of Designated Primary Market-Makers ("DPMs") in such trading crowds under Exchange Rules 8.80 and 8.81, each DPM has a general duty to administer and oversee the market in his appointed classes so as to foster full and fair competition among all orders represented in the crowd. Assertions have occasionally been made of certain DPM practices which, if they in fact occurred, would be inconsistent with the duty of DPMs to maintain and foster competitive markets. Of course, any such practices that are found to occur may lead to disciplinary proceedings for violation of Exchange rules. However, to minimize the likelihood that such practices will ever take place, the Exchange is issuing this Regulatory Circular, which presents a clear explanation of some of the more important responsibilities of DPMs in promoting competition in their trading crowds.

The DPM's Order Book Official Responsibilities

The DPM must perform all of the functions of the Order Book Official, pursuant to Rules 7.3 through 7.10. Only persons associated with the DPM organization who are members are allowed to execute orders and fulfill other member functions for the DPM. Non-member employees, including employees who wear "badges", are not allowed to execute orders or perform any other member function for the DPM.

In CBOE's competitive auction market, the potential for the highest bids and lowest offers to interact assures that executions will take place at the best available prices. In all trading crowds, including those that operate with a DPM, market makers and floor brokers acting on behalf of customers, market makers or other market professionals are important in providing liquidity to the market.

In a trading crowd that employs the Modified Trading System, it is the special responsibility of the DPM to assure that any market maker who wishes to make a market in any class of option is permitted to do so, and that the bids and offers of such a market

maker (or of a floor broker representing an order) are given the price and time priority to which they are entitled under Exchange Rules.

Included among the duties of a DPM is to assure that all bids and offers of market makers trading in-person at the DPM's station are promptly displayed if they improve the market. This requirement to display a market maker's better bid or offer applies even if the market maker's better bid or offer is for a smaller size than the size that the DPM may have committed to member firms concerning the size of the displayed quote in his assigned classes. (Rule 8.51.03 provides that market maker and other proprietary broker/dealer orders that in each case are for less than ten contracts and are represented in the crowd by the DPM or a floor broker should not be reflected in the displayed quote.)

The DPM's Floor Broker Responsibilities

Under Rule 6.43, the bids and offers of a DPM (whether bidding or offering on behalf of an agency order or for the DPM's own account) must be made by public outcry. When a DPM represents an order as agent, he is obligated under Rule 6.73 to use due diligence in representing agency orders that he holds as an agent, including those orders that may reside in the public limit order book. Under Rule 8.80(c)(8), the DPM is required to book all orders in his possession that are eligible to be booked. Where a DPM receives a marketable customer order, the DPM may execute such order without first placing it in the book. *The DPM's use of due diligence in executing an order includes making all persons in the trading crowd aware of his request for a quotation.*

The DPM's Market Maker Responsibilities

A DPM may never purchase (sell) options for his own account while in possession of an unexecuted market or marketable limit order to purchase (sell) the same option. A DPM may execute an agency order against his principal account only after giving the trading crowd an opportunity to match or better the DPM's quote. A DPM may not participate as principal in the execution of an order that the DPM represents as agent beyond the minimum level of "pro rata" participation provided for under Rule 8.80 as described below, unless a greater level of participation by the DPM is necessary to complete the execution of the order.

A DPM's right to participate as principal in a transaction is generally governed by the principles of time and price priority as set forth in Rule 6.45. Under these principles, if a DPM announces a bid (offer) for his own account ahead of other members in response to a request for a market from a member not acting on behalf of the DPM, the DPM is entitled to participate up to 100% in any resulting transaction. Under these same principles, even if the DPM is not first to announce a bid or offer, the DPM is nonetheless entitled to participate to whatever extent necessary to complete the execution of an order *after* taking into account the previously announced bids or offers of other members.

In addition to the above, Rule 8.80(c)(7)(ii) gives a DPM a special right to participate "pro rata" in a transaction even if the DPM's bid or offer is not entitled to priority under Rule 6.45, *but only if the DPM can establish that his previously established principle bid (offer) was equal to the highest bid (lowest offer) in the crowd.*

As interpreted by the MTS Appointment Committee and as described in Regulatory Circular RG-94-04 dated January 24, 1994 (and as further set forth in related regulatory circulars issued each calendar quarter thereafter) the DPM's special participation right when the DPM is not first to respond means that a DPM may participate in transactions up to but not in excess of the following levels:

Average Daily Volume Over
Previous Calendar Quarter

Participation Right During
Next Calendar Quarter

Up to 2500 contracts

40% per trade

From 2501 to 5000 contracts

30% per trade

Over 5000 contracts

No special right to participate

In respect of all multiply-traded option classes, the MTS Committee has established the DPM's special "pro-rata" participation level 40% per trade regardless of volume levels over the previous quarter.

A common misunderstanding is that a DPM is entitled to participate with another member who buys contracts from or sells to the book. Since a DPM's previously established principal bid (offer) could not have been equal to the book offer (bid), the DPM is not entitled to participate with a crowd member when that crowd member buys the book offer or sells to the book bid.

Questions concerning this memorandum and any other questions concerning the rights and obligations of DPMs may be directed to Edward L. Provost, Operations Planning Division, at 312-786-7717.