

IC03-18

February 12, 2003

To: CBOE Members

From: Financial Planning Committee

Re: Revised Fee Structure for Equity and QQQ Market Makers and DPMs

Beginning March 1, 2003, subject to SEC approval, CBOE will be implementing the Market Share Incentive Plan on a pilot basis. The plan, which was designed by the members of the Financial Planning Committee, is intended to financially reward market makers and DPMs who have a higher than average share of the total contracts traded in an individual class traded on our floor. Below are a series of questions that are intended to help CBOE members understand this new program.

- ***How will the Market Share Incentive Plan work?*** Basically, market maker and DPM transaction fees will be reduced as market share increases in a top 300 stock or QQQ option during a particular month. The fee reduction is composed of two parts. The first part of the fee reduction is based on actual market share. At 25% market share, fees are reduced by 1-cent per contract. For every 1% increase in market share the fee reduction also increases by 1-cent. See Table 1 below. In addition, market makers and DPMs will receive an additional fee reduction for increasing market share as compared to the prior six-month average for market share. See Table 2. The highest potential fee reduction is 24-cents per contract. As opposed to programs at other exchanges that penalize members when they fall below market share thresholds, our program will reward members when they exceed minimum levels or increase their market share.

Table 1 - Per Contract Credit for Better Than Average Market Share

| <u>Market Share</u> | <u>Credit Per MM Contract</u> |
|---------------------|-------------------------------|
| 25.0% | \$0.01 |
| 26.0% | \$0.02 |
| 27.0% | \$0.03 |
| 28.0% | \$0.04 |
| 29.0% | \$0.05 |
| 30.0% | \$0.06 |
| 31.0% | \$0.07 |
| 32.0% | \$0.08 |
| 33.0% | \$0.09 |
| 34.0% | \$0.10 |
| 35.0% | \$0.11 |
| 36.0% | \$0.12 |
| 37.0% | \$0.13 |
| 38.0% | \$0.14 |
| 39.0% | \$0.15 |
| 40.0% | \$0.16 |

Table 2 - Per Contract Credit for Increasing Market Share

| <u>Market Share Incr</u> | <u>Credit Per MM Contract</u> |
|--------------------------|-------------------------------|
| 1.0% | \$0.01 |
| 2.0% | \$0.02 |
| 3.0% | \$0.03 |
| 4.0% | \$0.04 |
| 5.0% | \$0.05 |
| 6.0% | \$0.06 |
| 7.0% | \$0.07 |
| 8.0% | \$0.08 |

- ***As a market maker or DPM, how will this program change the transaction fees I currently pay to CBOE?*** Market makers and DPMs are billed a CBOE transaction and trade match fee totaling 24-cents for every contract they trade. This fee is collected through your clearing firm. At the end of each month CBOE will calculate the market share of each option class and then send a credit through to each clearing firm who will then credit individual market maker and DPM accounts. All market makers and DPMs will be provided with reports showing the total credit they received along with all details supporting CBOE's calculations on or about the 10th business day of the subsequent month.
- ***What options classes will be included in this program?*** The top 300 stocks, in terms of total national volume, plus QQQ options will be included in this incentive program. The top 300 stocks represent about 85% of our total equity options volume. Including classes beyond this level did not make sense considering the swings in market share that can occur in lower volume stocks.
- ***Is this program permanent?*** In considering this proposal, the Board of Directors approved a pilot for this program that will begin March 1, 2003 and will end on June 30, 2003. During and immediately after the pilot we (Financial Planning and Market Performance Committees) will analyze our market share data to determine if the program is indeed increasing our market share. If the program is determined not to be effective or is creating some unintended results, then the program will end or be modified. If the incentive plan does appear to be working then we must go back to the Board of Directors to ask their approval to continue the program. Of course we will share our analysis with the membership along with our recommendation to the Board of Directors, whatever that turns out to be.
- ***Where will the money for this program come from?*** Through our Prospective Fee Reduction program, market maker and DPM transaction fees were reduced by 6-cents per contract beginning January 1st. This program and the general fee reduction will be discontinued on March 1 for all equity classes and QQQ, but will remain in place for all other option products. The savings realized by this action will be approximately equal to the cost of the Market Share Incentive Plan.
- ***How can I learn more about this incentive program?*** Members of the Financial Planning Committee will be coming to every trading station on the floor during the next few days. They will be distributing statements for each crowd that will show you the per contract credit you would have received had this plan been in place during the month of January. In addition, we will be holding meetings in the auditorium on the 4th floor that will allow you to ask more questions and better understand this new program. The meetings in the auditorium will be held on the following dates. **February 13th at 3:30 PM for Posts 1, 2 and 3; February 19th at 7:15 AM for Posts 4, 5; and 6; and February 20th at 3:30 PM for Posts 9, and 10, the Green Room, QQQ, MNX and NDX.**
- ***As a market maker, how can I help increase market share?*** A market maker can help by providing additional liquidity to the trading crowd. Additional liquidity in the trading crowd can be in the form of an accurate response to a request for a quote. Also, a market maker who currently sends orders to the ISE can post his/her bids and offers on CBOE. Although this generally requires a quote reporter today, tighter markets will result in fewer trades at ISE and more trades in your crowd.
- ***How will the introduction of the Hybrid System affect this program?*** In the Hybrid System market makers will be allowed to stream their own markets and size which will then result in

a consolidated crowd quote for CBOE. We believe that our displayed markets will be tighter and deeper, truly reflecting the liquidity that was always available on our floor. The display of our true markets will help increase our market share.

- **Why is market share important to CBOE and why should market makers care?** Market share is important to CBOE for a number of reasons but most importantly, we want our customers to think of CBOE first when making their order routing decisions. Being number 2 or number 3 in the U.S. options industry is not the position that will allow members to maximize their own profits, nor is it the position that will allow our owner/lessors to realize the economic return on their seat investment that historically they have come to expect. In addition, more volume means more revenue (transaction fees, OPRA revenue, etc.) for CBOE which will allow us to continue to invest the significant amount of money that is required to maintain a state-of-art trading environment that will best serve our members and the investing public. More revenue because of higher volume will also lessen the need to balance our budget by increasing market maker fees.

If you have any questions about this program we encourage you to come to one of the informational sessions. You can also speak to any member of the Financial Planning Committee or you may call Don Patton, CBOE’s Vice President & Controller, at (312) 786-7026.

| Schedule for Informational Meetings | |
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| <u>Date & Time</u> | <u>Crowd</u> |
| February 13, 3:30 PM | Posts 1, 2, and 3 |
| February 19, 7:15 AM | Posts 4, 5, and 6 |
| February 20, 3:30 PM | Posts 9, and 10; Green Room, QQQ, MNX, NDX |
| All meetings will be held in the Auditorium on the 4 th floor | |

CBOE Financial Planning Committee:

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| Dan Koutris, Chairman | Alan Dean | Stephen Donahue |
| Doug Edelman | Bill Ellington | Corey Fisher |
| Fred Goldman | Jeff Kaufmann | Kevin Keller |
| Tim Keller | John Robinson | Frank Roskiewicz |
| Bob Silverstein | Tim Sommerfield | |