

Date: January 15, 2002

Regulatory Circular RG02-03

To: All Designated Primary Market Makers

From: Division of Regulatory Services
Legal Division

Re: Limit Order Handling

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KEY ISSUES

- **Effective January 15, 2002, each Designated Primary Market Maker (“DPM”) is expected to execute or book, with certain exceptions, 90% of customer limit orders within 90 seconds or less.**
- **DPMs not meeting this standard will be subject to appropriate regulatory or disciplinary action as determined by the Business Conduct Committee (“BCC”).**
- **The Securities and Exchange Commission (“SEC”) has directed all floor-based options exchanges to impose this same limit order handling standard.**
- **The SEC has further directed that the standard be progressively improved to require the handling of 95% of eligible customer limit orders within 60 seconds or less beginning in July 2002, and beginning in January 2003 95% of such orders must be appropriately handled immediately but in a time frame not to exceed 30 seconds.**
- **These matters are discussed in more detail below.**

DISCUSSION

- Rule 8.85 requires that a DPM promptly execute or book all eligible customer limit orders upon receipt. Orders that would increase the size or improve the price of CBOE’s quote are automatically included in the disseminated quotes upon booking.
- In an Administrative Order dated September 11, 2000, the SEC directed each floor-based options exchange to enhance and improve its surveillance, investigative and enforcement programs for order handling, including the display of limit orders in the disseminated quotes.
- In August through October 2001 the Division of Regulatory Services (“Division”) initially advised each DPM that the BCC had determined that, with certain exceptions, it was reasonable to expect a DPM under normal market conditions to execute or book 90% of customer limit orders within 90 seconds or less.
- DPMs began at this time to receive routine reports reflecting their performance in comparison to this standard. The Division also met with representatives from each DPM to discuss limit order display obligations of DPMs as part of a non-disciplinary, educational regulatory initiative to improve the handling of limit orders.

- On December 20, 2001 the SEC directed the Exchange to move beyond the educational program to the imposition of appropriate regulatory and disciplinary actions. On January 9, 2002, all DPMs were provided written notice of the SEC's directive along with the DPM's limit order handling performance data for the month of December 2001.
- As described in the January 9, 2002 mailing, beginning with trade date January 15, 2002 the Division will record DPM limit order display data for purposes of administering appropriate regulatory or disciplinary actions in those cases where a DPM does not meet the BCC standard in any given month (expiration cycle). Limit order display failures generally will be aggregated for a month and considered a single offense for purposes of assessing disciplinary action.
- The Exchange has filed with the Securities and Exchange Commission ("SEC") a proposed fine schedule applicable to limit order display as follows: 1st offense: \$500--\$1,500; 2nd offense: \$1,000--\$3,000; 3rd offense: \$2,000--\$5,000; 4th offense: \$3,500--\$5,000 or BCC discretion. (See SR-CBOE-2001-71)
- In determining whether to impose a sanction and in establishing the severity of any such sanction, the Exchange may take into consideration extenuating or exacerbating factors, including but not limited to market conditions, the amount of business being handled at the DPM post and station, or whether the delay in order handling appears to have been deliberate or the result of negligence.
- Although all customer limit orders should be executed or booked promptly, the BCC has determined that limit orders subject to the 90-second handling standard do NOT include: broker-dealer orders, paper orders not received via PAR or Live Ammo, orders in excess of 100 contracts, orders that would lock or cross the NBBO if booked, orders received on PAR prior to the opening of trading and for 5 minutes following the opening of trading, whether at the beginning of a trading day or after a trading halt, contingency orders as defined in Rule 6.53(c), orders entered after 2:57 p.m. (CST), or orders the terms of which are delivered by the DPM to another exchange for an attempted execution.
- DPMs will continue to receive weekly report cards with supporting documentation. This information should be reviewed by the DPM and any corrections or mitigating factors provided to the Division's Department of Market Monitoring as soon as practical. Promptly at the end of each month the Division will provide written notice to each DPM that appears to have failed the 90%/90-second test. Pursuant to Rule 17.2, the DPM will be given 15 days from the date of notice to submit any reasons why disciplinary action should not be taken or should be limited.
- The SEC has directed all floor-based options exchanges to progressively improve the limit order handling standard as follows: July 2002: 95% of all eligible limit orders handled within 60 seconds or less; January 2003: 95% of all eligible limit orders handled immediately, but within a time frame not greater than 30 seconds. Beginning in February 2002, DPM report cards will include limit order handling data that reflects these pending standards, as well as the current standard for which disciplinary actions are presently applicable.