

after the date mentioned above, unless the Commission determines to order a hearing on the matter.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38634; File No. SR-CBOE-97-02]

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to the Use of Proprietary Brokerage Order Routing Terminals on the Floor of the Exchange

May 14, 1997.

I. Introduction

On January 21, 1997, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to extend from the Standard & Poor's 500 index ("SPX options") to the trading crowd in options on the Standard & Poor's 100 index ("OEX options") its existing policy adopted pursuant to Exchange Rule 6.23 whereby members are permitted to establish, maintain and use proprietary hand-held, brokerage order routing terminals and related systems ("Terminals") in the trading crowd.

The proposed rule change was published for comment in the **Federal Register** on February 20, 1997.³ No comments were received on the proposal. This order approves the proposal.

II. Background

On December 16, 1996, the Commission approved a proposal by the CBOE to adopt a policy pursuant to its Rule 6.23⁴ allowing the use of

proprietary brokerage order routing terminals and their related systems in the SPX trading crowd.⁵ Written Exchange approval is required prior to a member establishing, maintaining, or using a Terminal. The Exchange does not approve a Terminal unless and until the member who proposes to establish one on the floor of the Exchange has filed with the Exchange an "Application & Agreement for Brokerage/Order Routing Terminals in Trading Crowds" ("Application Agreement"). In addition, the original filing limited the use of Terminals to the SPX options trading crowd for the routing of orders in SPX options.

The Application Agreement approved by the Commission for use in the SPX trading crowd addressed several important issues including restrictions on the use of Terminals and the information thereon. The Application Agreement prohibits the operators of Terminals from trading with orders transmitted to the floor through Terminals except when certain conditions are met and prohibits the use of Terminals to make markets.

The Application Agreement requires an applicant to agree that it will not trade with orders transmitted through the Terminal, except when (1) No one else wants to trade with it (*i.e.*, the member is the contra-party of last recourse) or (2) an applicant is able to participate in the order on the same basis that other market makers who do not have priority participate. Under the second exception, the member may trade with an order as long as (a) The member in the trading crowd who is the first to respond to such order (other than the applicant) has priority in taking the other side of such order, and (b) the aggregate portion of such order taken by the applicant is not greater than the portion of the order taken by every other Exchange market maker in the crowd who wishes to participate in the order in the same aggregate quantity.

The Application Agreement also prohibits an applicant from using for their own benefit any information contained in any order in the Terminal system until that information has been disclosed to the trading crowd.

The Application Agreement also requires an applicant to agree that its Terminal will be used to receive brokerage orders only, and that it will not be used to perform a market making function. In adopting this restriction, the Exchange was concerned that Terminals may enable person not

subject to Exchange control to perform market making functions from off the floor of the Exchange without being burdened by the cost of maintaining an Exchange membership, or the obligations imposed on Exchange market makers.⁶

III. Description of the Proposal

The CBOE proposes to amend the policy adopted pursuant to its Rule 6.23 that would extend the use of proprietary brokerage order routing terminals and their related systems from the SPX options trading crowd to the OEX options trading crowd. Exchange members would still be required to obtain written approval from the Exchange to establish, maintain, or use a terminal in either of the two trading crowds. The Exchange would not approve the use of a Terminal unless and until the member who proposes to utilize it on the floor has filed with the Exchange an Application Agreement, and Terminals may only be used in the crowds trading SPX or OEX options.⁷ To accommodate this change, the application Agreement will also be amended to specifically allow for the use of Terminals in the OEX options trading crowd. The terms and restrictions of the Application Agreement remain unchanged and will be identical to those approved in the SPX-Terminal Approval Order as described above.

IV. Discussion

Section 6(b)(5) of the Act⁸ requires that the rules of an exchange be designated to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest. Section 6(b)(7) of the Act⁹ requires that the rules of an Exchange be in accordance with Section 6(d) of the Act,¹⁰ and in general provide a fair

⁶ In addition, the Application Agreement has provisions relating to the installation and use of Terminals. These provisions relate to surveillance, audit trails, compliance, physical, electrical and communications requirements and termination of approval for Terminals.

⁷ The Exchange requires applicants wishing to use Terminals in both the OEX and SPX options trading crowds to execute separate Application Agreements with the Exchange for each trading crowd. Telephone conversation between Tim Thompson, CBOE and David Sierazki, SEC, on May 13, 1997.

⁸ 15 U.S.C. 78f(b)(5).

⁹ 15 U.S.C. 78f(b)(7).

¹⁰ 15 U.S.C. 78f(d). Section 6(d) of the Act, among other things, requires that an exchange, in any proceeding to determine whether a member should

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 38268 (Feb. 11, 1997), 62 FR 7812 (Feb. 20, 1997).

⁴ CBOE Rule 6.23 provides that no member shall establish or maintain any telephone or other wire communications between his or its office and the Exchange without prior approval by the Exchange. The Exchange may direct discontinuance of any communication facility terminating on the floor of the Exchange.

⁵ See Securities Exchange Act Release No. 38054 (December 16, 1996), 61 FR 67365 ("SPX-Terminal Approval Order").

procedure for the disciplining of members and the prohibition or limitation by an exchange of a person's access to services offered by the exchange. Section 6(b)(7) of the Act¹¹ requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Section 11A(a)(1)(C)(ii) of the Act¹² states that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure fair competition among brokers and dealers. For the reasons set forth below, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, the requirements of Sections 6(b)(5), 6(b)(7), 6(b)(8), and 11A(a)(1)(C) of the Act.¹³

The Commission believes that the CBOE's proposal should foster coordination with persons engaged in facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market, and protect investors and the public interest by expediting and making more efficient the process by which members can receive OEX orders to be executed on the floor of the Exchange. The proposal also will promote fair competition among brokers and dealers and facilitate transactions in options on the Exchange. Finally, the Commission believes that the requirement that an applicant file the Application Agreement with the Exchange and comply with it is reasonable and ensures adequate surveillance and compliance with CBOE Rules.

The Commission notes that the substantive provisions set forth in the Application Agreement submitted with this proposal, are identical to those approved in the SPX-Floor Broker Terminal Approval Order.¹⁴ The Commission believes that the Exchange's policy regarding the use of Terminals and the Application Agreement provide a reasonable framework in which to introduce the use of Terminals to the OEX options

trading crowd. The Commission also believes that the requirement that an applicant file the Application Agreement with the Exchange and comply with it is reasonable and ensures adequate surveillance and compliance with CBOE rules. The Commission notes, however, that the Exchange is required to submit a proposed rule change with the Commission pursuant to Section 19(b) of the Act, if it wants to extend the use of Terminals beyond the SPX and OEX options trading crowds.

The Commission also believes that the termination procedures in the Application Agreement are consistent with the Act, including Sections 6(b)(7) and 6(d) of the Act,¹⁵ and are designed to provide affected members with adequate due process. The Commission notes that a member so affected could seek relief pursuant to the Hearings and Review provisions of Chapter XIX of the Exchange's Rules. These provisions provide specific procedures to seek Exchange hearing and review for persons aggrieved by action of the Exchange in terminating or enforcing the terms of the Application Agreement.¹⁶

As noted above, the Application Agreement prohibits a member or an associated person from trading with orders transmitted through a Terminal, unless no other member were to trade with the order, or the applicant were to trade on the same basis as other members who do not have priority. In addition, the Application Agreement prevents a member from using for its benefit information transmitted through a Terminal, before that information is disclosed to the trading crowd. The Commission believes that these restrictions are an appropriate measure to ensure that an applicant or one of its associated persons does not: (1) Interact with an order prior to information relating to such order becoming known to the trading crowd, which would be inconsistent with the open auction market principles governing the Exchange's trading system; or (2) effect transactions or change quotes in the Exchange's market or in the markets for the underlying interest or related interests before the information were available in the market. The Commission also believes that the two exceptions to the general restriction on trading with orders in the Terminal system are consistent with these concerns, and ensure that members using Terminals trade on the same terms

and conditions as other market participants and do not receive any trading advantages to interact with orders transmitted through the Terminals.

For the same reasons set forth in the Commission's findings in the SPX-Terminal Approval Order,¹⁷ the Commission believes that the market making prohibition on the use of Terminals in OEX options adequately balances the potential benefits to be derived from Terminals with the important regulatory issues that are raised in connection with the potential use of Terminals for off-floor market making in CBOE-listed options. Because off-floor market makers potentially would enjoy the benefits of other "public customers," while not having the concomitant obligations and responsibilities of CBOE market makers, the Commission does not believe it is unreasonable for the CBOE to determine that the introduction of unregulated market making through Terminals in OEX options could undermine its market maker system. Indeed, the CBOE's proposal will allow the expansion of an innovative technology into another extremely active trading crowd, while doing so in a manner designed to ensure the continued viability of its market maker system.¹⁸

The Commission also believes that the CBOE restriction on market making through the use of Terminals in OEX options has been effected in a clear and reasonable manner that is not ambiguous nor overbroad, and that takes into account regulatory and market impact concerns, including those relating to quote competition and price discovery.¹⁹ Notably, the CBOE's proposal does not bar all two-sided limit orders. Instead it only restricts the acceptance of orders placed in the performance of a market making function. The distinction between market making and brokerage activity is well established among market participants. Moreover, the language of the market making restriction expressly restricts only an aggregate pattern of orders, which indicates whether an investor is performing a market making function, not the occasional entry of two-sided limit orders. Thus, the restriction on Terminal use for routing limit orders is the minimum necessary

be disciplined, bring specific charges, notify such member of and provide him with an opportunity to defend himself against such charges, and keep a record.

¹¹ 15 U.S.C. 78f(b)(8).

¹² 15 U.S.C. 78k-1(a)(1)(C)(ii).

¹³ In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁴ See SPX-Terminal Approval Order, *supra* note 5. The discussion and findings in the SPX-Terminal Approval Order are incorporated herein.

¹⁵ See *supra* notes 9-10 and accompanying text.

¹⁶ See CBOE Rules 19.4, Hearing and 19.5 Review.

¹⁷ See SPX-Terminal Approval Order, *supra* note 5.

¹⁸ See *infra* note 22.

¹⁹ *CF.*, Securities Exchange Act Release No. 25842 (June 23, 1988), 53 FR 24539 (approving certain restrictions on the use of telephones on the floor of the New York Stock Exchange), *aff'd per curiam*, 866 F.2d 47 (2d Cir. 1989).

for the CBOE to bar Terminal use for off-floor market making.

The Commission also emphasizes that it expects the CBOE to interpret the term "market making" in accordance with its traditional definition as defined under the Act, *i.e.*, holding one's self out as being willing to buy and sell a particular security on a regular or continuous basis.²⁰ The definition of market making should not capture parties who enter orders on one side of the market; nor would it capture parties who enter two-sided limit orders on occasion. A party would not be deemed to be engaging in market making unless it regularly or continuously holds itself out as willing to buy *and* sell the security.²¹

By approving this proposed rule change, the Commission is not stating that it is impermissible for an options exchange to permit users of Terminals or other similar devices to make two-sided markets. Indeed, the CBOE may determine to reconsider its decision not to permit users of Terminals to engage in market making at some future time. Nevertheless, while it is not illegal to permit off-floor market making, the Commission believes that it is within the CBOE's prerogative as an exchange to prohibit it. In approving the market making restriction in the SPX-Terminal Approval Order the Commission noted that the CBOE was particularly concerned that off-floor market making effectively would establish a market making structure devoid of affirmative market making obligations that could result in less deep and liquid markets during periods of market stress, when off-floor Terminal market makers would not be required to continue making markets. The Commission believes that these concerns are reasonable. The Commission's approval of the proposed rule change reflects the Commission's belief that the CBOE may act incrementally in approving the use of Terminals for transactions in SPX, and now OEX options, given that the CBOE is still learning about the possible impact of Terminals upon its market.²²

²⁰ See, e.g., 15 U.S.C. 78c(a)(38); Securities Exchange Act Release No. 36719A (Sept. 6, 1996), 61 FR 48290, 48316 (Sept. 12, 1996).

²¹ Securities Exchange Act Release No. 36719A (Sept. 6, 1996), 61 FR 48290, 48316 (Sept. 12, 1996). The Commission notes that a broker using a Terminal may receive numerous orders from multiple customers, some of which are on the bid side and others on the offer side of an SPX series. This is consistent with a brokerage function, not a market making function. If, however, a particular customer of a broker regularly or continuously places two-sided limit orders, then the CBOE might, under certain circumstances, reach a different conclusion as to the nature of the function being performed by the broker and the customer.

²² The Commission recognizes that markets for certain equity options can be less deep and liquid

In summary, while the CBOE's restrictions on the use of Terminals raise regulatory issues, the Commission believes that, within the context of the OEX options trading crowd, the market making restriction is an acceptable exercise of the Exchange's rulemaking authority. While the Commission recognizes that there may be different ways to address the regulatory issues presented by off-floor market making through the use of Terminals, the Act does not dictate that any particular approach be taken. The Commission believes that the manner in which the Exchange has chosen to address the regulatory issues presented by off-floor market making reflects the considered judgment of the CBOE regarding the attributes of Exchange membership and the organization of its trading floor, and is a fair exercise of its powers as a national securities exchange.

For the reasons stated above, and the findings set forth in the SPX-Terminal Approval Order,²³ the Commission believes that the Exchange's proposal to extend the policy regarding the use of Terminals to the OEX options trading crowd is consistent with the Act.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-CBOE-97-02) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁵

Margaret H. McFarland,
Deputy Secretary.

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than the OEX market. However, the rule change approved today concerns the use of Terminals only in the OEX crowd. The Commission will consider the merits of permitting the use of Terminals to represent two-sided limit orders that effectively create regular two-sided markets in less liquid options crowds when it is presented with that issue.

²³ See SPX-Terminal Approval Order, *supra* note 5.

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 C.F.R. 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38633; File No. SR-CBOE-94-53]

Self-Regulatory Organizations; Notice of Filing of Amendment Nos. 2 and 3 to Proposed Rule Change by the Chicago Board Options Exchange, Incorporated Relating to a Determination of the Exchange's Office of the Chairman Under Exchange Rule 4.10(b)(3)

May 14, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on April 8, 1997, and May 13, 1997, respectively, the Chicago Board Options Exchange, Incorporated ("Exchange" or "CBOE") filed with the Securities and Exchange Commission ("SEC" or "Commission") Amendment Nos. 2 and 3 to its previously filed proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE.² The Commission is publishing this notice to solicit comments on the policy of the Exchange's Office of the Chairman from interested persons.

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

The CBOE is proposing to amend SR-CBOE-94-53 and the text of the Regulatory Circular which was attached as Exhibit A to the amendments. The Regulatory Circular is directed to options market-maker clearing firms and describes certain financial requirements the Exchange's Office of the Chairman has determined to apply to these Exchange members pursuant to Exchange Rule 4.10(b)(3). The text of the Regulatory Circular is available at the Office of the Secretary, CBOE and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filings with the Commission, CBOE included statements concerning the purpose of and basis for the policy of the Exchange's Office of the Chairman. The text of these statements may be examined at the places specified in Item IV below. The CBOE has

¹ 15 U.S.C. 78s(b)(1).

² The proposed rule change was noticed for comment in Securities Exchange Act Release No. 35282 (February 2, 1995), 60 FR 6577. Amendment No. 1 to the proposed rule change was noticed for comment in Securities Exchange Act Release No. 36458 (November 6, 1995), 60 FR 57255.