

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43839; File No. SR-CBOE-00-61]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. To Change the Capitalization Transfer Fee Applicable to Designated Primary Market-Makers

January 12, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 22, 2000, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. On December 4, 2000, the Exchange submitted Amendment No. 1 to the proposed rule change.³ On December 13, 2000, the Exchange submitted Amendment No. 2 to the proposed rule change.⁴ On January 10, 2001, the Exchange submitted Amendment No. 3 to the proposed rule change.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The CBOE proposed to amend its rules regarding application of the fee for changes in ownership of Designated Primary Market Makers ("DPMs"). Below is the complete text of the proposed rule change. Proposed new

text is in *italics*. Proposed deletions are in [brackets].

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Chapter VIII—Market-Makers, Trading Crowds and Designated Primary Market-Makers

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Transfer of DPM Appointments

Rule 8.89. (a)–(e) No change.
(f) The approval or failure to approve a proposed transfer of a DPM appointment, *and the application of the transfer fee under Interpretation .02 of this Rule to a transfer, are* [is] subject to direct review by the Board of Directors upon receipt by the Secretary of the Exchange, within ten (10) days of the time the Board is notified of the decision [of the MTS Committee is announced], of (i) a written request for such review made by a person aggrieved by the decision, specifying why the aggrieved person believes the decision of the Committee should be reversed or modified [(in the case of a failure to approve an application as submitted)] or (ii) a request for review made by at least five Directors of the Exchange (in any case). *For purposes of this Rule, a person must be aggrieved as described in Chapter XIX of the Exchange's rules.*

* * * Interpretations and Policies:

.01 No change.

.02 [Any DPM that is allocated, after June 29, 1999, one or more option classes traded on the Exchange prior to that date shall be subject to a transfer fee in the event of a change in the capitalization of the DPM during the five year period following the allocation of the first such option class to the DPM. For purposes of this transfer fee, a change in the capitalization of a DPM shall be deemed to include any sale, transfer, or assignment of any ownership interest in the DPM or any change in the DPM's capital structure, voting authority, or distribution of profits or losses. This transfer fee shall be equal to the larger of (i) (the applicable percentage set forth below) × (the actual dollar value of the change in capitalization of the DPM as determined by the Exchange) × (the percentage of the DPM's Market-Maker trading volume in its capacity as a DPM in the previous 12 months attributable to option classes allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) and (ii) (the applicable percentage set forth below) × (the current level of overall DPM profitability per contract as determined by the Exchange based on DPM financial reporting) × (the DPM's Market-Maker trading volume in the previous 12 months in option classes

allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) × (2) × (the percentage change in the DPM's capitalization as determined by the Exchange). The applicable percentage to be used in the formulas above to determine the transfer fee to be assessed to a DPM shall be 50% in the first year of the five year period during which the DPM is subject to this transfer fee, 40% in the second year, 30% in the third year, 20% in the fourth year, and 10% in the fifth year.]

(a) *Certain transfers of interest in DPM appointments that occur after October 20, 2000 shall be subject to a DPM transfer fee. The intent of the Rule is to apply a transfer fee in those instances where one or more principals in the DPM exit or significantly reduce their participation in the DPM operation. The intent of the Rule is not to assess the transfer fee to any transaction that enables a DPM to add new capital, to replace a capital partner, to merge with an existing DPM (where all pre-existing partners continue their participation in the new DPM), or that makes small changes in the ownership or profit sharing arrangement of the DPM. The MTS Committee shall determine, based on the intent of this Rule, whether the transfer fee is applicable to specific transactions.*

(c) *Factors to be considered in determining whether a transfer of an interest in a DPM appointment is subject to the transfer fee under this Interpretation .02 may include, but are not limited to, any one or more of the following:*

i. *Is new capital being contributed to the DPM by the new principal(s)?**

ii. *Are the original principals maintaining their level of capital contributions to the DPM* or withdrawing capital?*** If the original principals are retaining a profit allocation but are not maintaining their level of capital contributions to the DPM, have the original principals incurred financial losses with respect to their investment in the DPM?*

iii. *How is the profit allocation structure changing?*

iv. *What are the profit percentages allocated to the original principals in relation to the profit percentages allocated to the new principals? Are the profit percentages allocated to the new principals greater than the profit percentages allocated to the original principals?*** If yes, does the difference reflect a difference in capital contributed?**

v. *What are the profit percentages allocated to the principals who are active in the management of the DPM in relation to the profit percentages*

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, the CBOE re-designated the filing as a submission pursuant to Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2), rather than Section 19(b)(3)(A) of the Act, 15 U.S.C. 78s(b)(3)(A). See letter from Steve Youhn, Attorney, CBOE, to Deborah Flynn, Senior Special Counsel, Division of Market Regulation ("Division"), SEC, dated December 1, 2000 ("Amendment No. 1").

⁴ In Amendment No. 2, the CBOE confirmed that its recusal standards would apply to the procedures of the Modified Trading System ("MTS") Committee described herein, and clarified certain portions of the text and description of the proposed rule change. See letter from Steve Youhn, Attorney, CBOE, to Deborah Flynn, Senior Special Counsel, Division, SEC dated December 8, 2000 ("Amendment No. 2").

⁵ In Amendment No. 3, the CBOE amended the text of the proposed rule change to specify the formula for determining the amount of any fee imposed, and made further clarifications to the text and description of the proposed rule change. See letter from Steve Youhn, Attorney, CBOE, to Deborah Flynn, Senior Special Counsel, Division, SEC, dated December 28, 2000 ("Amendment No. 3").

allocated to those principals that are primarily investors in the DPM? Are the profit percentages allocated to principals who are active in management greater than the profit percentages allocated to principals who are primarily investors?*

Has the profit allocation split between these two categories of principals changed significantly?*

vi. Is the purpose of a change in profit percentages to compensate a DPM employee?*

vii. What is the level of consideration that is being received by the original principals?

viii. Has management of the DPM changed significantly?*

ix. Will the original principals who were active in the management of the DPM continue in that role?*

An asterisk (*) next to a factor indicates that a positive response to the question posed would be a factor in favor of not imposing the transfer fee. A double asterisk (**) next to a factor indicates that a positive response to the question posed would be a factor in favor of imposing the transfer fee.

(c) The amount of the transfer fee applicable to a specific transaction shall be equal to (the total value of the consideration, as determined by the MTS Committee, to be paid to the original DPM principals prior to June 30, 2004) \times (the percentage of the DPM's Market-Maker trading volume in its capacity as a DPM in the previous 12 months attributable to option classes allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) \times (the applicable percentage set forth below.) The fee rate percentage to be applied above is: 40% during the time period until June 29, 2001; 30% during the time period from June 30, 2001 to June 29, 2002; 20% during the time period from June 30, 2002 to June 29, 2003; and 10% during the time period from June 30, 2003 to June 29, 2004. The transfer fee expires on June 30, 2004. If the transfer of interest occurs over a period of years, the fee rate percentage applied will be consistent with the year in which the transfer occurs. As an example, if the transfer of a DPM is to occur equally over three years commencing in November 2000, then the fee rate percentage applied would be 40% for the first portion of the transfer, 30% for the second portion of the transfer, and 20% for the last portion of the transfer.

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

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

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

1. Purpose

In 1999, CBOE instituted a floor-wide DPM system and awarded the appointment of options classes to DPMs at no cost in exchange for a long-term commitment to the Exchange and a fee on subsequent changes of ownership ("transfer fee"). Currently, the transfer fee, contained in Interpretation and Policy .02 to CBOE Rule 8.89, is imposed on DPMs that undergo changes in their capitalizations during a determined five-year period.⁶

As originally proposed, the Exchange detailed three primary purposes for the transfer fee. First, it was designed to provide those who own DPMs with a significant incentive to capitalize sufficiently the DPM. Second, because the Exchange believes that the allocation of existing options classes to DPMs bestows upon them a valuable right for which they paid no consideration, the Exchange believed it

⁶ See Securities Exchange Act Release No. 43186 (August 21, 2000), 65 FR 51880 (August 25, 2000) (Approval of File No. SR-CBOE-99-37) (approving current transfer fee scheme). The transfer fee generally is equivalent to an applicable percentage of the larger of: (i) the applicable percentage set forth below \times (the actual dollar value of the change in capitalization of the DPM as determined by the Exchange) \times (the percentage of the DPM's market maker trading volume in its capacity as a DPM in the previous 12 months attributable to option classes allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) and (ii) the applicable percentage set forth below \times (the current level of overall DPM profitability per contract as determined by the Exchange based on DPM financial reporting) \times (the DPM's market maker trading volume in the previous 12 months in option classes allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) \times (2) \times (the percentage change in the DPM's capitalization as determined by the Exchange). The applicable percentage to be used in the formulas above to determine the transfer fee to be assessed to a DPM shall be 50% in the first year of the five year period during which the DPM is subject to this transfer fee, 40% in the second year, 30% in the third year, 20% in the fourth year, and 10 percent in the fifth year.

would be inequitable for those DPMs to sell those rights shortly thereafter by transferring all or a portion of their interest in the DPM organization to other parties. Thus, the transfer fee was established to discourage these types of transactions, or if they were to occur, to require a significant portion of the value of the transaction to be paid to the Exchange. Finally, the transfer fee was intended to assure that DPMs maintained a long-term commitment to the Exchange.

The Exchange believes that the DPM transfer fee, as structured, is not accomplishing these primary objectives and that it may be, in fact, having an unintended effect on the ability of CBOE to attract and retain well-capitalized DPMs. Specifically, the Exchange notes that the potential application of the transfer fee may be suppressing a number of proposed transactions that could strengthen the financial resources of DPMs.⁷ As originally proposed, the Exchange stated that it would consider changes to the DPM transfer fee if subsequent experience indicated that such changes were necessary and appropriate.⁸ In this respect, the Exchange notes that the Exchange's MTS Committee, the Lessors Advisory Committee, and the Floor Directors Committee have evaluated the DPM transfer fee and determined to modify the transfer fee so that it accomplishes its original primary objectives.

The proposed changes are intended to permit a DPM to add new capital, to make small changes in ownership or profit sharing, to replace a capital partner, or to merge with other DPMs (where all pre-existing partners continue their participation in the new DPM), all without triggering the transfer fee. Consistent with the intent of the rule, a transfer fee would continue to be assessed in cases where one or more principals of a DPM exit[s] or significantly reduce[s] their participation in the DPM operation.

To accomplish these changes, the Exchange proposes to amend Interpretation .02 to CBOE Rule 8.89 to modify the instances in which the fee

⁷ In this respect, the Exchange notes that the other options exchanges allow specialist assignments to be sold or transferred without the imposition of a fee, leaving CBOE at a competitive disadvantage. For example, on competing exchanges, specialists may take on new partners willing to make capital contributions, they may become part of larger market making organizations, or they may merge with other specialist units to combine their resources. All of these actions, which would trigger application of CBOE's DPM transfer fee, occur on other exchanges without those competing specialist units paying any transfer fee.

⁸ See Securities Exchange Act Release No. 41872 (September 13, 1999), 64 FR 51158 (September 21, 1999) (Notice of Filing of SR-CBOE-99-37).

would be assessed. Specifically, the Interpretation would be modified to allow the MTS Committee to analyze each proposed transaction to determine whether the transfer fee should be applied. Factors to be considered in making such a determination may include, but would not be limited to, one or more of the following:

- i. Is new capital being contributed to the DPM by the new principal(s)?*
- ii. Are the original principals maintaining their level of capital contributions to the DPM* or withdrawing capital**? If the original principals are retaining a profit allocation but are not maintaining their level of capital contributions to the DPM, have the original principals incurred financial losses with respect to their investment in the DPM?
- iii. How is the profit allocation structure changing?
- iv. What are the profit percentages allocated to the original principals in relation to the profit percentages allocated to the new principals? Are the profit percentages allocated to the new principals greater than the profit percentages allocated to the original principals?*** If yes, does the difference reflect a difference in capital contributed?*
- v. What are the profit percentages allocated to the principals who are active in the management of the DPM in relation to the profit percentages allocated to those principals that are primarily investors in the DPM? Are the profit percentages allocated to principals who are active in management greater than the profit percentages allocated to principals who are primarily investors?* Has the profit allocation split between these two categories of principals changed significantly?***
- vi. Is the purpose of a change in profit percentages to compensate a DPM employee?*
- vii. What is the level of consideration that is being received by the original principals?
- viii. Has management of the DPM changed significantly?***
- ix. Will the original principals who were active in the management of the DPM continue in that role?*

An asterisk (*) next to a factor listed above indicates that a positive response to the question posed would be a factor in favor of not imposing the transfer fee. A double asterisk (**) next to a factor indicates that a positive response to the question posed would be a factor in favor of imposing the transfer fee.

If after its review the MTS Committee determines that the proposed transaction should be subject to the

transfer fee, the MTS Committee shall impose the fee. The Exchange proposes to replace the existing formulas for determining the amount of the transfer fee with a new formula contained in Interpretation .02(c) to Rule 8.89. The amount of the transfer fee applicable to a specific transaction would be equal to: (the total value of the consideration, as determined by the MTS Committee, to be paid to the original DPM principals prior to June 30, 2004) × (the percentage of the DPM's Market-Maker trading volume in its capacity as a DPM in the previous 12 months attributable to option classes allocated to the DPM after June 29, 1999 that were traded on the Exchange prior to that date) × (the applicable percentage set forth below.) The fee rate percentage to be applied above is: 40% during the time period until June 29, 2001; 30% during the time period from June 30, 2001 to June 29, 2002; 20% during the time period from June 30, 2002 to June 29, 2003; and 10% during the time period from June 30, 2003 to June 29, 2004.⁹ The transfer fee would expire on June 30, 2004.

The Exchange also proposes to amend section (f) to Rule 8.89 to create a review process relating to the application of the transfer fee. Accordingly, this provision allows a person aggrieved by the decision to appeal the MTS Committee's decision to assess the transfer fee, as well as its determination as to the amount of the fee, to the Board of Directors of the Exchange. Additionally, the proposed rule would allow the Board of Directors to call MTS Committee decisions relating to the assessment of the fee for review on the Board's own motion upon the request of five or more directors.

Finally, CBOE proposes to make the effective date of this proposal retroactive to October 20, 2000. If this proposal is not granted retroactive status, the current transfer fee structure will have been applicable to only one transaction. By making the effective date October 20, 2000, the Exchange proposes to avoid assessing a fee to a transaction that, had it occurred one month later, would not have been subject to the fee. Thus, the Exchange does not believe that the interests of fairness are served by assessing a fee to a transaction that occurred during this interim period, a period in which the

⁹ If the transfer of ownership occurs over a period of years, the fee rate percentage applied will be consistent with the year in which the transfer occurs. As an example, if the transfer of a DPM is to occur equally over three years commencing in November 2000, then the fee rate percentage applied would be 40% for the first portion of the transfer, 30% for the second portion of the transfer, and 20% for the last portion of the transfer.

Exchange already had begun discussions to amend the transfer fee structure.

The Exchange believes that the proposed changes advance the primary objectives of the DPM transfer fee, as identified above. First, the Exchange believes that the proposed changes will facilitate a DPM's ability to maintain sufficient capital to operate as a DPM by allowing it to enter into transactions that enhance its financial operating structure without automatically subjecting it to the DPM transfer fee. As the amount of the business transacted on the Exchange continues to grow, so will a DPM's capital needs. The proposed changes recognizes this and allow DPMs to respond accordingly without being subject to the transfer fee.

Second, that Exchange believes that the proposed changes also continue to ensure that a DPM maintains its long-term commitment to the Exchange. The Exchange believes that by enhancing its capital structure, a DPM is making a long-term commitment to the Exchange that it intends to operate in that capacity for an extended period. For this reason, the Exchange believes it would be counter-productive to assess a fee on those types of transactions.

Third, the Exchange believes the proposed amendments should prevent the "quick sale" of a DPM interest for a profit. The Exchange believes that the proposal advances this objective because it allows DPMs to enhance their capital structures without paying a transfer fee, provided that one or more principals do not exit or significantly reduce their participation in the DPM operation. If, however, the original principals do exit the business or significantly reduce their participation, they will be assessed a fee consistent with the intent of the rule. Accordingly, the proposal should continue to result in the levying of a transfer fee when a DPM tries to profit from the "quick sale" of its interest.

Finally, the Exchange notes that the full membership has had an opportunity to review the proposed changes. In this regard, on November 1, 2000, the Chairmen of the Floor Directors, MTS Appointments, and Lessors Advisory Committees distributed to the membership an Information Circular that discussed the changes and requested comment. To date, the Exchange has received no written comments in opposition to the amendment of the rule.¹⁰ The

¹⁰ The Exchange notes that the Chairman of the Floor Directors Committee received one comment via telephone regarding the proposed amendment.

Committees have discussed this issue in great detail and believe that the proposed changes will be beneficial to the operation of the Exchange.¹¹

2. Basis

For these reasons, the Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,¹² in general, and further the objectives of Section 6(b)(5)¹³ in particular, because it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The CBOE does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

On November 1, 2000, the Chairmen of the Floor Directors, MTS Appointments, and Lessors Committees distributed to the membership an Information Circular that discussed the prescribed changes and requested comment. To date, the Exchange has received no written comments in opposition to the amendment of the rule. The Exchange notes that the Chairman of the Floor Directors Committee received, via telephone, the views of one commenter who supported abolishing the transfer fee altogether.¹⁴ The Exchange believes the proposed amendments will enable it to achieve the original intent of the transfer fee,

This commenter supported abolishing the transfer fee altogether. The Exchange also received a copy of a letter sent to the Commission by another commenter. This commenter opposed the filing of the proposed rule change under Section 19(b)(3)(A) of the Act, 15 U.S.C. 78s(b)(3)(A), which would have rendered it effective on filing. The commenter believed that the proposed rule change should be subject to public comment and review pursuant to Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2). See letter from Lawrence J. Blum to Jonathan G. Katz, Secretary, SEC, dated November 24, 2000. The filing was subsequently re-filed under Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2). See Amendment No. 1, *supra* note 3.

¹¹ The Exchange believes the proposed changes will address the potential shortcomings of the current DPM transfer fee. However, the Exchange will continue to evaluate the fee and make changes to it in the future if such changes are deemed necessary. Any such changes would be submitted to the Commission pursuant to Section 19(b) of the Act (15 U.S.C. 78s(b)).

¹² 15 U.S.C. 78f(b).

¹³ 15 U.S.C. 78f(b)(5).

¹⁴ See *supra* note 10.

thereby negating the need to abolish the fee altogether. The Exchange also received a copy of a letter sent to the Commission from another commenter. This commenter opposed allowing the proposed changes to become effective on filing, and urged that they be subject to public comment and review.¹⁵ In Amendment No. 1 to the proposed rule change, the Exchange re-designated the filing as a submission pursuant to Section 19(b)(2) of the Act.¹⁶

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-00-61 and should be submitted by February 12, 2001.

¹⁵ See *supra* note 10.

¹⁶ 15 U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Jonathan G. Katz,

Secretary.

[FR Doc. 01-1806 Filed 1-19-01; 8:45 am]

BILLING CODE 8010-01-M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43835; File No. SR-CHX-00-31]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to Preopening Orders

January 11, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 18, 2000, the Chicago Stock Exchange, Incorporated ("Exchange" or "CHX") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CHX. On December 20, 2000, the Phlx filed Amendment No. 1 to the proposed rule change.³ The Commission is published this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend the CHX rule governing preopening orders in Nasdaq/NM securities to explicitly define "preopening orders" in Nasdaq/NM securities, and to explicitly provide for a single price opening at or better than the NBBO at the first unlocked, uncrossed market.

Below is the text of the proposed rule change. Proposed new language is in *italics* and proposed deletions are in brackets.

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¹⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Kathleen M. Boege, Associate General Counsel, CHX, to Nancy, J. Sanow, Assistant Director, Division of Market Regulation, Commission, dated December 20, 2000 ("Amendment No. 1"). In Amendment No. 1, the CHX clarified the rule text to reflect that the 8:25 a.m. cutoff time for preopening orders is "Central Time".