

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45677; File No. SR-CBOE-2002-07]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. Relating to the Execution of Incoming RAES Orders Against Manual Quotes

March 29, 2002.

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 February 14, 2002, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") 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 CBOE.³ On February 28, 2002 and March 25, 2002, the Exchange submitted Amendment Nos. 1⁴ and 2⁵ to the proposal, respectively. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval to the proposed rule change, as amended.

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

The Exchange proposes to amend CBOE Rules 6.8 and 6.43 regarding orders entered into its Retail Automatic Execution System ("RAES") for

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange initially submitted this proposal to the Commission on December 28, 2001 as part of File No. SR-CBOE-2001-70 and subsequently withdrew that portion of the filing relating to manual quotes. See Securities Exchange Act Release No. 45490 (March 1, 2002), 64 FR 25091 (March 8, 2002) (notice soliciting public comment on File No. SR-CBOE-2001-70).

⁴ See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Deborah Flynn, Division of Market Regulation ("Division"), Commission, dated February 27, 2002 ("Amendment No. 1"). In Amendment No. 1, the Exchange proposed additional rule text to clarify the intended operation of the proposal.

⁵ See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Deborah Flynn, Division, Commission, dated March 22, 2002 ("Amendment No. 2"). In Amendment No. 2, the Exchange proposes changes to the rule text of CBOE Rules 6.8 and 6.43 with regard to the dissemination of manual quotes. In addition, the Exchange proposes to amend CBOE Rule 6.8 regarding the obligation of Designated Primary Market Makers ("DPMs") to use their best efforts to ensure that a member that enters a manual quote will receive an allocation of incoming order(s) for up to such member's disseminated size.

execution against manual quotes. Below is the text of the proposed rule change. Additions are italicized.

* * * * *

Rule 6.8: RAES Operations

(a)-(c) no change

(d)(i)-(v) no change

(vi) *RAES orders will not execute against manual quotes (as defined in Rule 6.43). When a manual quote is the disseminated quote, orders submitted for automatic execution in that series shall be automatically routed to PAR, BART, or Live Ammo. When orders route to PAR or Live Ammo as a result of a manual quote, Designated Primary Market Makers ("DPMs") will use their best efforts to attempt to ensure that the member will receive an allocation of incoming order(s) for up to his/her disseminated size.*

* * * * *

Rule 6.43 Manner of Bidding and Offering

(a) Bids and offers to be effective must be made at the post by public outcry, except that bids and offers made by the Board Broker or Order Book Official shall be effective if displayed in a visible manner in accordance with Rule 7.7. All bids and offers shall be general ones and shall not be specified for acceptance by particular members.

(b) *Members of the trading crowd may verbalize quotes ("manual quotes") to be input into Exchange systems by quote reporters for dissemination to the Options Price Reporting Authority ("OPRA"). Manual quotes must be for a minimum size of five (5) contracts. A manual quote will remain as the Exchange's disseminated quote until executions deplete the size, until the market maker or floor broker withdraws the quote, or until matched or improved by Autoquote or improved by an order in the electronic Book.*

* * * * *

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 III below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

CBOE Rule 6.8 governs the operation of RAES. RAES generally provides for automatic executions at the Exchange's disseminated quote, regardless of whether the disseminated quote represents the Autoquote-generated price or a manual quote put up on behalf of a market maker or floor broker. Once executed, RAES trades are assigned to market makers in accordance with the procedures contained in CBOE Rule 6.8.06. CBOE Rule 6.8.06 does not provide for the automatic allocation of RAES orders to a specific market maker, even if the RAES trade occurred at that market maker's quote.

The Exchange proposes that when a manual quote⁶ represents the Exchange's disseminated quote, RAES would not automatically execute an order and assign it to market participants. Rather, the Exchange's Order Routing System ("ORS") would block incoming orders from automatic execution and instead, immediately route them to Exchange's Public Automated Routing System ("PAR"), the Exchange's Booth Automated Routing Terminal ("BART"), or Live Ammo,⁷ where they would be executed manually at the disseminated price up to the disseminated size.⁸ Electronic orders would continue to be blocked from receiving automatic execution as long as a manual quote is the Exchange's disseminated quote. A manual quote would remain as the Exchange's disseminated quote until executions deplete the size, until the market maker or floor broker withdraws the quote, or until Autoquote matches the manual quote.⁹ The minimum size

⁶ See Amendment No. 2, *supra* note 5. Pursuant to proposed paragraph (b) to CBOE Rule 6.43, a manual quote is a quote that is verbalized by an Exchange member to be input into Exchange systems by a quote reporter for dissemination to OPRA.

⁷ The Live Ammo electronic screen displays market orders or limit orders that improve the market. See CBOE Rule 7.4(g).

⁸ See Proposed CBOE Rule 6.8(d)(vi).

⁹ See Amendment No. 2, *supra* note 5. Pursuant to proposed CBOE Rule 6.43(b), a member's manual quote will lose priority when matched by the Autoquote. The Commission notes that the Exchange filed a proposed rule change, File No. SR-CBOE-2002-05, proposing a new rule, CBOE Rule 6.8B, that would require that a member that places an order in EBook that is the Exchange's disseminated quote retain priority to the extent of the size of his quote, even if such member's bid or offer is subsequently matched by Autoquote. CBOE staff represents that, in connection with its proposed rule change filed in SR-CBOE-2002-05,

order that could be manually entered by a crowd member would be five contracts. Accordingly, any member in the crowd would have the ability to cause a manual quote that improves the disseminated quote to become the new disseminated quote, provided that quote is for at least five contracts.¹⁰

When orders route to PAR or Live Ammo as a result of a manual quote, DPMs would use their "best efforts" to attempt to ensure that the member that put up the quote will receive the incoming order(s) for up to his/her disseminated size.¹¹ The term "best efforts" entails several safeguards designed to help facilitate the manual assignment of RAES orders to the member that put up the quote. First, the Exchange notes that given the open outcry environment of the trading floor, DPMs would more than likely hear the member verbalizing the order. Second, other market participants would likely hear the order being verbalized and would be able to inform the DPM of the identity of the market maker whose quote was disseminated. Third, the member who put the quote up would have a strong interest in stepping forward and claiming the contracts for which he just bid/offered. Fourth, because a manual quote is a member's quote, it may not be representative of the DPM's market. As such, the DPM would have a strong interest in determining against whose quote incoming RAES orders executed, or else the entire crowd would be obligated. Finally, the Exchange notes that quote reporters are present in the crowd and should know which member submitted a manual quote for dissemination.

The Exchange believes that this proposal represents a substantial step toward enhancing incentives to members to quote competitively by providing them with an opportunity to receive allocations of trades that execute against quotes they caused to be disseminated. Upon approval of the filing, the Exchange commits to provide notification to its members apprising them of the substance of the filing (*i.e.*, that RAES orders would not automatically execute against manual quotes). This notification process would include distribution of a circular to

it will amend proposed CBOE Rule 6.43 to clarify that at such time as the CBOE Rule 6.8B applies to a given option series, the provisions of CBOE Rule 6.8B governing priority of orders in EBook shall supersede the provision of proposed CBOE Rule 6.43(b) under which a member would lose priority when Autoquote matches his manual quote. Telephone conversation between Steve Youhn, CBOE, and Elizabeth King, Division, Commission, on March 28, 2002.

¹⁰ See Proposed CBOE Rule 6.8(d)(vi).

¹¹ See Amendment No. 2, *supra* note 5.

members as well as reference on the CBOE Web site.

2. Statutory Basis

For the reasons discussed above, the Exchange believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of section 6(b) of the Act.¹² Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)¹³ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, 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.

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

No written comments were solicited or received with respect to the proposed rule change.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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 also will be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2002-07 and should be submitted by April 26, 2002.

¹² 15 U.S.C. 78f(b).

¹³ 15 U.S.C. 78f(b)(5).

IV. Commission Findings and Order Granting Accelerated Approval of the Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange,¹⁴ and, in particular, section 6(b)(5) of the Act¹⁵ in that the proposed rule change has been designed to remove impediments to and to perfect the mechanism of a free and open market and a national market system, while also protecting investors and the public interest. Specifically, the Commission believes that the proposed rule change, which allocates incoming orders to the floor broker or market maker that established the Exchange's disseminated quote, should encourage competition among trading crowd participants by providing a greater incentive for floor brokers and market makers to improve the Exchange's disseminated quote. In this regard, the Commission notes that the Exchange's rules would provide that a member who enters a manual quote that improves the Exchange's disseminated quote should receive the benefit of trading with incoming orders at such member's disseminated price and size.

The Commission notes that any member of the trading crowd who submits a manual quote that improves the Exchange's disseminated quote would be considered to be the responsible broker or dealer pursuant to Rule 11Ac1-1(c) under the Act.¹⁶ Consequently, the Exchange has an obligation pursuant to Rule 11Ac1-1(b) under the Act to disseminate the member's quote and the member has an obligation pursuant to Rule 11Ac1-1(c) under the Act to be firm at that price for up to its disseminated size. In addition, the Commission believes that investors should benefit from the opportunity to receive executions of their orders at improved prices.

The Commission finds good cause, consistent with section 19(b)(2) of the Act,¹⁷ to grant the Exchange's request for approval of the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that granting accelerated approval to the proposed rule change and amendments thereto should allow the CBOE to quickly

¹⁴ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 17 CFR 240.11Ac1-1.

¹⁷ 15 U.S.C. 78s(b)(2).

implement its proposed improvement to its market to encourage greater competition among trading crowd participants.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,¹⁸ that the Exchange's proposed rule change, as amended, (File No. SR-CBOE-2002-07) is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45676; File No. SR-CBOE-2001-70]

Self-Regulatory Organizations; Order Granting Accelerated Approval of a Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to the Dissemination of Options Quotations With Size

March 29, 2002.

I. Introduction

On December 28, 2001, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission" or "SEC"), 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 amend CBOE Rules 6.8 and 8.51 to accommodate the introduction of an options quotation with size ("quotes with size" or "QWS") system with an automatic decrementation feature ("AutoDec"). On January 14, February 27, and March 1, 2002, respectively, the Exchange submitted Amendment Nos. 1, 2, and 3 to the proposal.³ Notice of the proposed rule change, as amended, appeared in the **Federal Register** on March 8, 2002.⁴ The Commission received no comments on the proposal. This order approves the proposed rule

change, as amended, on an accelerated basis.

II. Description of the Proposal

The CBOE proposes to implement a QWS system with an AutoDec feature that would enable the Exchange to disseminate options quotations with a size that reflects previous executions. The Exchange proposes to implement the QWS system gradually on a series-by-series basis.⁵

AutoDec

For those series in which the exchange disseminates options quotations with size, the QWS system would automatically decrement all executions for each individual series calculated by Autoquote⁶ that execute automatically. For example, if the Exchange disseminates a size of 100 contracts, the trading crowd would be firm for 100 non-broker-dealer contracts executed automatically or via open outcry⁷ at the disseminated price, until that size was exhausted or until the quote was refreshed. Under the proposal, the appropriate Floor Procedure Committee ("FPC") would retain its authority to establish the eligible order size permitted to be sent to RAES for a particular series at a number less than the disseminated size. Therefore, for classes in which the Exchange does not disseminate options quotations with size, CBOE Rule 6.8(c)(v) would remain in effect.⁸

While the disseminated size would reflect the number of contracts that may be executed automatically or via open outcry at a particular price, trades executed in open outcry would *not* cause the disseminated size to decrement automatically. Under these circumstances, the Exchange would be firm for executions that in the aggregate sum up to more than its disseminated size. The number of contracts in a particular series that may receive automatic execution at the disseminated price, however, may not exceed the disseminated size.⁹

⁵ For those series in which the Exchange does not implement the QWS system, the Exchange would continue to publish firm quote sizes on its website. See CBOE Rule 8.51(c)(2).

⁶ For purposes of this rule filing, Autoquote shall refer to any automated quotation updating system, whether Exchange-owned or proprietary.

⁷ The Commission's Quote Rule obligates the responsible broker or dealer to also be firm for the disseminated size for orders executed in open outcry. Rule 11Ac1-1 under the Act, 17 CFR 240.11Ac1-1.

⁸ CBOE Rule 6.8(c)(v) provides that the appropriate FPC shall determine the size of orders eligible for entry into RAES. The eligible order size for non-QWS series must be 100 contracts or less.

⁹ See proposed CBOE Rule 6.8.09(a)(1). Notwithstanding this provision, all orders rerouted

Consistent with the current provisions of CBOE Rule 6.8, orders eligible for automatic execution would not be executed automatically at prices inferior to the national best bid or offer. If an incoming electronic order exceeds the disseminated size, that order would receive a partial automatic execution for up to the disseminated size at the disseminated price. The balance of the order would be automatically routed away from RAES to the Exchange's Public Automated Routing System ("PAR"), the Exchange's Booth Automated Routing Terminal ("BART"), or Live Ammo¹⁰ and thus may receive a dual-price execution.¹¹

30-Second Reroute Period

When the disseminated size is decremented to zero by automatic executions, for a period not to exceed 30-seconds ("reroute period"), all subsequent orders in that series that are otherwise eligible for RAES would be automatically routed away from RAES to either PAR, BART, or Live Ammo.¹² During the reroute period, the Exchange would disseminate a size of "1" with the same price. Upon expiration of the reroute period timer, new electronic orders would be eligible for automatic execution up to the refreshed disseminated size. The duration of the reroute period would be configurable by the DPM on a class basis and may not exceed 30-seconds. The appropriate FPC may, however, establish a ceiling on that duration not to exceed thirty seconds. The DPM may manually override the reroute period timer by submitting a new quote prior to the expiration of the reroute period. For example, if the reroute period timer is established at 15-seconds, the DPM may manually send a new quote at any time prior to the expiration of the 15-second reroute period, thereby allowing orders to be eligible for automatic execution at the refreshed price.

Upon expiration of the reroute period, subsequent incoming orders that are eligible for automatic execution would

from Live Ammo back to RAES would receive an automatic execution at the disseminated price even if the cumulative size of such rerouted orders exceeds the disseminated size. See proposed CBOE Rule 6.8.09(a)(2). See also *infra* note 13.

¹⁰ The Live Ammo electronic screen displays market orders or limit orders that improve the market. See CBOE Rule 7.4(g).

¹¹ Orders would route to BART only if a firm so chooses.

¹² Orders received during the reroute period would not be held for the duration of the reroute period. Rather, as incoming electronic orders are received during the reroute period they would be sent upon receipt either to PAR, BART, or Live Ammo. The appropriate FPC shall determine by class the location to which to route those RAES orders that are submitted during the reroute period.

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letters from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Deborah Flynn, Division of Market Regulation ("Division"), SEC, dated January 11, 2002 ("Amendment No. 1"); Steve Youhn, CBOE, to Deborah Flynn, Division, SEC, dated February 13, 2002 ("Amendment No. 2"); and Steve Youhn, CBOE, to Deborah Flynn, Division, SEC, dated February 28, 2002 ("Amendment No. 3").

⁴ See Securities Exchange Act Release No. 45490 (March 1, 2002), 64 FR 25091.