

following the Exempted Trade-Through.<sup>5</sup>

Article XX, Rules 37(a)(3) and 37(b)(6) of the CHX Rules, which govern execution of limit orders in a CHX specialist's book, provides for execution of such orders at the limit price when certain conditions occur in the primary market. Specifically, these provisions obligate a CHX specialist to fill limit orders in his book if there is a trade-through of the limit price in the primary market. These rule provisions were enacted as a means of attracting order flow to the CHX, by guaranteeing that a limit order resident in a CHX specialist's book would receive a fill if the primary market traded through the limit price. The CHX specialist is willing to provide this "trade-through protection" to its customer limit orders because the CHX specialist can seek relief via ITS in the event of a trade-through.

Now that the Exemption has become effective, however, certain primary market trade-throughs in ETFs that will trigger a CHX specialist's obligation to provide trade-through protection will now constitute Exempted Trade-Throughs, and will leave the CHX specialist without recourse to seek satisfaction from the primary market. While the CHX believes that certain CHX specialists may still wish to provide trade-through protection to their limit orders for business and marketing reasons, the CHX believes that trade-through protection should no longer be mandated in the case of Exempted Trade-Throughs. The attached rule would permit, but would not require, a CHX specialist firm to fill limit orders in his book when an Exempted Trade-Through occurs in the primary market.

## 2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b).<sup>6</sup> The CHX believes the proposal is consistent with Section 6(b)(5) of the Act<sup>7</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments, and to

<sup>5</sup> Under current ITS rules and practice, if an ITS participant trades through the quotation of another ITS participant, thereby violating the ITS trade-through prohibition, the non-violating participant is entitled to send an administrative message noting the trade-through and the violating participant is required to respond with a commitment to trade at the price and size quoted by the non-violating participant.

<sup>6</sup> 15 U.S.C. 78(f)(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

perfect the mechanism of, a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or received.

## 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 other 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 the 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 CHX. All submissions should refer to File No. SR-CHX-2002-31 and should be submitted by October 23, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46557; File No. SR-CHX-2002-29]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of proposed Rule Change by The Chicago Stock Exchange, Incorporated Relating to Execution of Limit Orders Following Exempted ITS Trade-Through

September 26, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 4, 2002, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rule change as described in Items I, II and III below, which Items have been substantively prepared by the Exchange. On September 25, 2002, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> 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 Exchange proposes to amend certain provisions of CHX Article XX, Rule 37, which governs, among other things, execution of limit orders in a CHX specialist's book following a trade-through in the primary market. Specifically, the CHX seeks to render voluntary a CHX specialist's obligation to fill limit orders in the specialist's book following a primary market trade-through, if such trade-through constitutes an Exempted Trade-Through.

<sup>8</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, the Exchange consented to the Commission's treatment of the proposed rule change as being filed as a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of an existing rule pursuant to Section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. 78s(b)(3)(A). In addition, the Exchange clarified that the proposed rule change was being submitted as a 30-day pilot.

The text of the proposed rule change, which would be in effect for a pilot period of 30 days, is available at the Commission and at the CHX.

## 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 CHX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The CHX 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

On August 28, 2002, the Commission issued an order granting a *de minimis* exemption (the "Exemption") for transactions in certain exchange-traded funds ("ETFs") from the trade-through provisions of the Intermarket Trading System ("ITS") Plan.<sup>4</sup> The Exemption was proposed by Commission staff to permit rapid execution of orders in certain ETFs at prices that may trade through the quotations of other markets, including the NBBO price. Because Exempted Trade-Throughs will, by definition, be exempt from ITS restrictions, a market participant that reports execution of an Exempted Trade-Through will not be required to satisfy an administrative request from any ITS participant for satisfaction following the Exempted Trade-Through.<sup>5</sup>

Article XX, Rules 37(a)(3) and 37(b)(6) of the CHX Rules, which govern

<sup>4</sup> See Securities Exchange Act Release No. 46428, 67 FR 56607 (September 4, 2002). At present, the Exemption extends to transactions in three designated ETFs—the Nasdaq-100 Index ("QQQ"), the Dow Jones Industrial Average ("DIAMONDS") and the Standard & Poor's 500 Index ("SPDRs")—when the transactions are "executed at a price that is no more than three cents lower than the highest bid displayed in CQS and no more than three cents higher than the lowest offer displayed in CQS" (each, an "Exempted Trade-Through"). The Exemption is effective as of September 4, 2002.

<sup>5</sup> Under current ITS rules and practice, if an ITS participant trades through the quotation of another ITS participant, thereby violating the ITS trade-through prohibition, the non-violating participant is entitled to send an administrative message noting the trade-through and the violating participant is required to respond with a commitment to trade at the price and size quoted by the non-violating participant.

execution of limit orders in a CHX specialist's book, provide for execution of such orders at the limit price when certain conditions occur in the primary market. Specifically, these provisions obligate a CHX specialist to fill limit orders in his book if there is a trade-through of the limit price in the primary market. These rule provisions were enacted as a means of attracting order flow to the CHX by guaranteeing that a limit order resident in a CHX specialist's book would receive a fill if the primary market traded through the limit price. The CHX specialist is willing to provide this "trade-through protection" to its customer limit orders because the CHX specialist can seek relief via ITS in the event of a trade-through.

Now that the Exemption has become effective, however, certain primary market trade-throughs in ETFs that will trigger a CHX specialist's obligation to provide trade-through protection will now constitute Exempt Trade-Throughs, and will leave the CHX specialist without recourse to seek satisfaction from the primary market. While the CHX believes that certain CHX specialists may still wish to provide trade-through protection to their limit orders for business and marketing reasons, the CHX believes that trade-through protection should no longer be mandated in the case of Exempted Trade-Throughs. The proposed rule, in effect for a pilot period of 30 days, would permit, but would not require, a CHX specialist firm to fill limit orders in his book when an Exempted Trade-Through occurs in the primary market.

#### 2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national exchange, and, in particular, with the requirements of section 6(b).<sup>6</sup> The CHX believes the proposal is consistent with Section 6(b)(5) of the Act<sup>7</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments, and to perfect the mechanism of, a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will impose

any inappropriate burden on competition.

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

No written comments were either solicited or received.

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

The foregoing rule change constitutes a stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Exchange and therefore, has become effective pursuant to section 19(b)(3)(A)(i) of the Act<sup>8</sup> and subparagraph (f)(1) of Rule 19b-4 thereunder.<sup>9</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

## 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 submissions, 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 CHX. All submissions should refer to File No. SR-CHX-2002-29 and should be submitted by October 23, 2002.

<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>8</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>9</sup> 17 CFR 240.19b-4(f)(1).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46561; File No. SR-OCC-2002-09]

### Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Fixing Settlement Prices in the Event of Market Disruptions

September 26, 2002.

#### I. Introduction

On May 17, 2002, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-OCC-2002-09 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on August 1, 2002.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

#### II. Description

The primary purpose of the proposed rule change is to ensure that OCC will have the ability, in case of market disruptions, to conform settlement prices for OCC-cleared security futures and index options, where appropriate, to settlement prices that are used for related products (such as other futures on the same security or index) traded in other markets and not cleared by OCC. The proposed rule change will primarily affect the fixing of exercise settlement amounts for expiring options as well as final settlement prices for maturing futures contracts.<sup>3</sup> OCC does not anticipate any substantive change in its present policy with respect to fixing settlement prices for options that are exercised prior to expiration.<sup>4</sup>

In the event of an interruption in the markets for an underlying security or one or more component securities in an underlying index, OCC needs to have discretion to act to set final settlement values in a manner that avoids inconsistencies between the futures and options markets and among futures markets.<sup>5</sup> At times, investors employ hedging and other trading strategies that involve holding positions in different contracts on the same underlying security or index. These strategies are based on the expectation that the values of different derivative contracts with the same underlying interest will have a predictable relationship to one another. This expectation may not be met when trading halts or other disruptions in markets for the underlying interests require the derivatives markets to fix settlement prices using prices or values other than those that would normally be used. In such cases, discrepancies in settlement prices can occur unless prices for derivative products traded in different markets are fixed using a common method. Unless such coordination occurs, investors with positions in options and futures that were intended to hedge one another may find that the positions do not produce the anticipated offset.

In the spring of 2000, OCC attempted to solve the problem of a potential disconnect between the options and futures markets in setting final index contract settlement prices by conforming its rules more closely to the rules of the Chicago Mercantile Exchange ("CME") as then in effect.<sup>6</sup> OCC's rule change broadened the circumstances under which OCC could fix a settlement price for expiring index options to include situations where market disruptions affected one or more

securities in an index (as opposed to "securities representing a substantial portion of the value of an index") and added a paragraph relating solely to expiring options specifically permitting OCC to fix settlement prices based on the next opening prices for one or more component stocks.<sup>7</sup>

Effective December 1, 2001, CME changed its rules governing its method of fixing final settlement prices for each of its index futures products under certain circumstances. CME's newly amended rules provide that if the primary market for a component stock opens for trading on the day scheduled for determination of a final settlement price but the component stock does not trade while the market is open, the price of the component stock for purposes of calculating the final settlement price will be based on the last sale price of the stock *unless* CME's president or his delegate determines that there is a reasonable likelihood that trading in the component stock will occur shortly. In that case, for purposes of determining the final settlement price, the price of the component stock may be based on the opening price of the component stock on the next day the component stock is traded on its primary market.<sup>8</sup>

OCC's existing rules do not authorize OCC to fix a settlement price based on a stock's next opening price in situations where the stock's primary market is open but the stock does not trade. SR-OCC-00-01 authorized the use of opening values only in cases where a stock's primary market did not open or remain open for trading at or before the time when the exercise settlement amount would ordinarily be determined. As a result, OCC is again faced with a potential disconnect between its rules and CME's rules.

The most fundamental aspect of SR-OCC-00-01 was that for the first time OCC was allowed to fix a settlement

<sup>5</sup> This rule change will affect the fixing of final settlement prices for futures contracts and exercise settlement amounts for options. However, in the case of options exercised other than at expiration, coordination with other markets is ordinarily not a significant factor because either there is no concurrent final settlement in related futures markets or an investor need not exercise the option.

<sup>6</sup> For example, CME Rule 2003.A., which governs the method for determining the final settlement price for Standard & Poor's 500 Stock Index Futures, provided (at that time) as follows:

If the primary market for a component stock in the index does not open on the day scheduled for determination of the Final Settlement Price, then the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the opening price of that stock on the next day that its primary market is open for trading.

If a component stock in the index does not trade on the day scheduled for determination of the Final Settlement Price while the primary market for that stock is open for trading, the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the last sale price of that stock.

<sup>7</sup> Securities Exchange Act Release No. 42769 (May 9, 2000), 65 FR 31036 (May 15, 2000) [SR-OCC-2000-01].

<sup>8</sup> For example, CME added the following underlined language to CME Rule 2003.A:

If a component stock in the index does not trade on the day scheduled for determination of the Final Settlement Price while the primary market for that stock is open for trading, the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the last sale price of that stock. *However, if the President of the Exchange or his delegate determines that there is a reasonable likelihood that trading in the stock shall occur shortly, the President or his delegate may instruct that the price of stock shall be based, for the purposes of calculating the Final Settlement Price, on the opening price of the stock on the next day that it is traded on its primary market. Factors to be considered in determining whether trading in the stock is likely to occur shortly shall include the nature of the event and recent liquidity levels in the affected stock.*

<sup>10</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> Securities Exchange Act Release No. 46265 (July 25, 2002), 67 FR 49973.

<sup>3</sup> These will include single stock futures and narrow-based index futures as well as broad-based index futures subject to the exclusive jurisdiction of the Commodity Futures Trading Commission.

<sup>4</sup> That general policy will be restated in new Interpretation .02 to Section 4 of Article XVII of OCC's by-laws.