

be available for inspection and copying at the principal offices of Amex. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Amex-2005-010 and should be submitted on or before March 18, 2005.

#### **IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change**

After careful consideration, 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, with the requirements of Section 6(b)(5) of the Act.<sup>25</sup> The Commission notes that it has previously approved the listing of securities the performance of which have been linked to, or based on, the Index.<sup>26</sup>

Accordingly, the Commission finds that the listing and trading of the Notes based on the Index is consistent with the Act and will promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and, in general, protect investors and the public interest consistent with Section 6(b)(5) of the Act.<sup>27</sup>

The requirements of Section 107A of the Company Guide were designed to address the concerns attendant to the trading of hybrid securities, like the Notes. The Commission notes that the Amex will distribute a circular to its membership calling attention to the specific risks associated with the Notes, and impose other requirements of its rules as described in the proposal above.

<sup>25</sup> See *id.*

<sup>26</sup> See Securities Exchange Act Release Nos. 50016 (July 14, 2004), 69 FR 43639 (July 21, 2004) (approving the listing and trading of Morgan Stanley PLUS Notes linked to the performance of the Nikkei 225); 49999 (July 9, 2004), 69 FR 43023 (July 19, 2004) (approving the listing and trading of Contingent Principal Protection Notes linked to the performance of the Nikkei 225); 49670 (May 7, 2004), 69 FR 27959 (May 17, 2004) (approving the listing and trading of Accelerated Return Notes linked to the Nikkei 225 for Nasdaq); and 38940 (August 15, 1997), 62 FR 44735 (August 22, 1997) (approving the listing and trading of Market Index Target-Term Securities the return on which is based on changes in the value of a portfolio of 11 foreign indexes, including the Nikkei 225).

<sup>27</sup> 15 U.S.C. 78f(b)(5). In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

The Commission notes, in addition, that Morgan Stanley will deliver a prospectus in connection with the initial sales of the Notes. By imposing the hybrid listing standards, suitability, disclosure, and compliance requirements noted above, the Commission believes the Amex has addressed adequately the potential problems that could arise from the hybrid nature of the Notes.

In approving the product, the Commission recognizes that the Index is a modified capitalization-weighted index<sup>28</sup> based on 225 common stocks traded on the TSE, which represent a broad cross-section of Japanese industry. The Underlying Stocks are listed in the First Section of the TSE and are, therefore, among the most actively traded stocks on the TSE. Given the composition of the Index, the Commission believes that the listing and trading of the Notes that are linked to the Index should not unduly impact the market for the underlying securities comprising the Index or raise manipulative concerns.<sup>29</sup>

The Commission also believes that any concerns that a broker-dealer, such as Morgan Stanley, or a subsidiary providing a hedge for the issuer, will incur undue position exposure are minimized by the size of the Notes issuance in relation to the net worth of Morgan Stanley.<sup>30</sup>

Finally, the Commission notes that the value of the Index will be calculated once per minute throughout the TSE trading day and will be readily accessible to U.S. investors. The Exchange represents that the Index will be calculated, published, and disseminated solely by NKS. NKS will also make the changes in the composition of the Index. Although NKS is under no obligation to continue

<sup>28</sup> See *supra* note 5.

<sup>29</sup> The issuer Morgan Stanley disclosed in the prospectus that the original issue price of the Notes includes the agent's commissions and the cost of hedging Morgan Stanley's obligations under the Notes. According to Morgan Stanley, this fact is expected to adversely affect the secondary market prices of the Notes. Such hedging activity must, of course, be conducted in accordance with applicable regulatory requirements.

<sup>30</sup> See Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving the listing and trading of notes whose return is based on the performance of the Nasdaq-100 Index) (File No. SR-NASD-2001-73); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving the listing and trading of notes whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index) (File No. SR-Amex-2001-40); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving the listing and trading of notes whose return is based on a weighted portfolio of healthcare/biotechnology industry securities) (File No. SR-Amex-96-27).

the calculation and dissemination of the Index, in the event the calculation and dissemination every minute of the Index is discontinued, Amex represents that it will contact Commission staff and consider prohibiting the continued listing of the Notes.

The Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of the notice of filing thereof in the **Federal Register**. The Exchange has requested accelerated approval because this product is similar to several other instruments currently listed and traded on the Amex.<sup>31</sup> The Commission believes that the Notes will provide investors with an additional investment choice and that accelerated approval of the proposal will allow investors to begin trading the Notes promptly. Additionally, the Notes will be listed pursuant to Amex's existing hybrid security listing standards as described above. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,<sup>32</sup> to approve the proposal on an accelerated basis.

#### **V. Conclusion**

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>33</sup> that the proposed rule change (SR-Amex-2005-010) is hereby approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>34</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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#### **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-51220; File No. SR-CBOE-2004-89]

#### **Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Reduced-Value Options on the Russell 2000 Stock Index**

February 17, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

<sup>31</sup> See *supra* note 25.

<sup>32</sup> 15 U.S.C. 78f(b)(5) and 78s(b)(2).

<sup>33</sup> 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

<sup>34</sup> 17 CFR 200.30-3(a)(12).

(“Act”)<sup>1</sup> and Rule 19b–4 thereunder,<sup>2</sup> notice is hereby given that on December 23, 2004, the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by CBOE. On February 10, 2005, CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On February 14, 2005, CBOE filed Amendment No. 2 to the proposed rule change.<sup>4</sup> The Exchange filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act<sup>5</sup> and Rule 19b–4(f)(6) thereunder,<sup>6</sup> which renders it effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

## **I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change**

CBOE proposes to amend certain of its rules to provide for the listing and trading of reduced-value options on the Russell 2000® Index (“Russell 2000” or “Index”), a broad-based securities index. Options on each index would be cash-settled, a.m.-settled, and would have European-style expiration. The text of the proposed rule change is available on CBOE’s Web site (<http://www.cboe.com>), at the CBOE’s principal office, and at the Commission’s Public Reference Room.

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

In its filing with the Commission, 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 Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> See Form 19b–4, dated February 10, 2005, which replaced the original filing in its entirety (“Amendment No. 1”).

<sup>4</sup> See Form 19b–4, dated February 14, 2005, which was a partial amendment (“Amendment No. 2”). In Amendment No. 2, CBOE represented, in part, that in the event the Frank Russell Company ceases to maintain or calculate the Index or if values are not disseminated every 15 seconds by a widely available source, CBOE will notify the Division of Market Regulation (“Division”).

<sup>5</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>6</sup> 17 CFR 240.19b–4(f)(6).

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

#### **1. Purpose**

The purpose of the proposed rule change is to amend CBOE rules to allow the Exchange to list and trade reduced-value options on the Russell 2000.<sup>7</sup> Specifically, CBOE proposes listing cash-settled, a.m.-settled, European-style index options that are based on one-fifth (1/5th) and one-tenth (1/10th) the value of the Russell 2000 (“Reduced-Value Options”). The Russell 2000 is a broad-based securities index created in 1984 by the Frank Russell Company for the purpose of tracking the performance of small-cap companies. The Russell 2000 is a capitalization-weighted index and includes only common stocks belonging to corporations domiciled in the United States and its territories and that are traded on the New York Stock Exchange or the American Stock Exchange. The Russell 2000 is completely reconstituted annually to ensure that larger stocks do not distort the performance and characteristics of the true small-cap market.<sup>8</sup> The Russell 2000 includes the smallest 2000 securities in the Russell 3000.<sup>9</sup> CBOE has been trading European-style, cash-settled options on the Russell 2000 since 1992.

The proposed rule change will allow CBOE to attract additional business from customers that may not otherwise be able to invest in regular Russell 2000 options. Over the years, the value of the Russell 2000 has significantly increased such that, as of December 15, 2004, the value of the index stood at approximately 643. Accordingly, the premium for Russell 2000 options also has increased proportionately, making the use of Russell 2000 options as a

<sup>7</sup> The Exchange currently is approved to list and trade European-style, cash-settled options, including long-term index option series (“LEAPS”), on the Russell 1000 Index, Russell 2000 Index, Russell 3000 Index, Russell 1000 Growth Index, Russell 1000 Value Index, Russell 2000 Growth Index, Russell 2000 Value Index, Russell 3000 Growth Index, Russell 3000 Value Index, Russell Midcap Index, Russell Midcap Growth Index, Russell Midcap Value Index, Russell Top 200® Index, Russell Top 200® Growth Index, and the Russell Top 200® Value Index. See Securities Exchange Act Release Nos. 49384 (March 10, 2004), 69 FR 12720 (March 17, 2004); 48591 (October 2, 2003), 68 FR 58728 (October 10, 2003); 31382 (October 30, 1992), 67 FR 52802 (November 5, 1992).

<sup>8</sup> See <http://www.russell.com> or <http://www.cboe.com> for further description and background of the Index.

<sup>9</sup> The Russell 3000® Index contains the largest 3,000 companies incorporated in the United States and the U.S. territories. The companies are ranked by total market capitalization.

hedging tool cost-prohibitive for some retail investors. To make trading Russell 2000 options accessible to a greater range of investors, CBOE proposes to introduce two new options contracts that are based on one-fifth (1/5th) and one-tenth (1/10th) the value of the Russell 2000, respectively. For example, a January (2005) Russell 2000 640 call would cost an investor approximately \$1,560, whereas, with adoption of the proposed reduced-value contracts, the 1/5th version of the same call would cost an investor \$312.00 and a 1/10th version of the call would cost only \$156.00.<sup>10</sup> CBOE will make no modifications to the Russell 2000 index methodology or calculation, for which the Frank Russell Company is the reporting authority. In addition to regular index options, the Exchange also may provide for the listing of LEAPS in accordance with CBOE Rule 24.9.<sup>11</sup>

The Exchange believes that offering reduced-value Russell 2000 options will provide an important opportunity for investors to hedge and speculate upon the market risks associated with the stocks comprising the Russell 2000, without having to extend great outlays of capital. This should attract a wider range of investors and, in turn, create a more active and liquid trading environment for all options on the Russell 2000. The Exchange will continue listing and trading the existing Russell 2000 options contracts, and the reduced-value Russell 2000 options will trade under their own trading symbols that are different than Russell 2000 trading symbol (RUT).

The Commission and the Options Clearing Corporation will be notified of the trading symbol, and CBOE will issue a circular detailing the option contract specifications to CBOE membership prior to the listing of options series on the reduced-value Russell 2000. In addition, the Exchange will disseminate prices for the reduced-value Russell 2000 contracts every 15 seconds through the Option Price Reporting Authority. The Exchange will notify the Division of Market Regulation immediately in the event the Frank Russell Company ceases to maintain or calculate the Index or if the Index values are not disseminated every 15 seconds by a widely available source.<sup>12</sup> CBOE further represents that,

<sup>10</sup> Estimates are based on a randomly selected last sale price (intra-day) for the 2005 January 640 call on the Russell 2000 during the December 15, 2004 trading day. The approximate cost to an investor does not include applicable fees or commissions that may be incurred in the execution of trades.

<sup>11</sup> This is consistent with the Exchange’s ability to list LEAPS on all other Russell Indexes. See *supra* note 7.

<sup>12</sup> See Amendment No. 2.

if the Russell 2000 Index ceases to be maintained or calculated, or if the Index values are not disseminated every 15 seconds by a widely available source, it will not list any additional series for trading and will limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

Strike prices for the reduced-value Russell 2000 contracts will be set to bracket the index in 2½ point increments for strikes at or below 200 and in 5-point increments for strikes above 200. The minimum tick size for series trading below \$3 will be \$0.05 and for series trading above \$3 the minimum tick will be \$0.10. The trading hours for reduced-value options on the Russell 2000 will be 8:30 a.m. to 3:15 p.m. (c.s.t.).

#### *Position and Exercise Limits.*

Consistent with CBOE Rule 24.4(d), positions in reduced-value index options shall be aggregated with positions in full-value indices. As such, the position and exercise limits applicable to the one-fifth value and one-tenth value Russell 2000 options shall be, conversely, increased by a factor of 5 and 10, respectively. To illustrate, for the purposes of determining the applicable position limits for the one-tenth value Russell 2000, ten reduced-value Russell 2000 contracts would be equal to one Russell 2000 contract and, for the one-fifth value Russell 2000, five reduced-value Russell 2000 contracts would be equal to one Russell 2000 contract. Reducing the contract size of the Russell 2000 Index option by one-tenth (or one-fifth) while increasing the position limit from 50,000 contracts to 500,000 contracts (or from 50,000 contracts to 250,000), would have no effect on the monetary value of the portfolio that could be controlled by a particular person or firm. This also is consistent with previous filings in which the Exchange introduced reduced-value versions of other broad-based indexes.<sup>13</sup>

The Exchange also proposes making a technical correction to Rule 24.4(d), which provides, “[p]ositions in reduced-value index options shall be aggregated with positions in full-value indices. For such purposes, ten (10) reduced-value contracts shall equal one contract.” The latter sentence in this rule presumes that all reduced-value index options shall be reduced only to

one-tenth the value of the original index. The Exchange believes that it is more appropriate to amend this sentence in the form of an example to illustrate the calculations to make based on the ratio of the reduced-value contract being proposed. As such, the rule will now provide two examples; one in which the index would be reduced by one-tenth and one in which the index would be reduced by one-fifth.

*Exercise and Settlement.* Exercise and settlement on the reduced-value Russell 2000 options will be identical to existing options on the Russell 2000. The reduced-value options will expire on the Saturday following the third Friday of the expiration month. Trading in the expiring contract month will normally cease at 3:15 p.m. (CST) on the business day preceding the last day of trading in the component securities of the Index (ordinarily the Thursday before expiration Saturday, unless there is an intervening holiday). The exercise settlement value of the Index at option expiration will be calculated by Reuters, on behalf of the Frank Russell Company, based on the opening prices of the component securities on the last business day prior to expiration. If a component security fails to open for trading, the exercise settlement value will be determined in accordance with CBOE Rules 24.7(e) and 24.9(a)(4). When the last trading day is moved because of Exchange holidays (such as when CBOE is closed on the Friday before expiration), the last trading day for expiring options will be Wednesday, and the exercise settlement value of index options at expiration will be determined at the opening of regular trading on Thursday.

*Maintenance.* Because the Russell 2000 is to be monitored and maintained by the Frank Russell Company, the Frank Russell Company will be responsible for making all necessary adjustments to the indexes to reflect component deletions, share changes, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to restructuring, mergers, or spin-offs involving the underlying components. Some corporate actions, such as stock splits and stock dividends, require simple changes to the available shares outstanding and the stock prices of the underlying components. Other corporate actions, such as share issuances, change the market value of the Index and would require the use of an index divisor to effect adjustments.

The Russell 2000 is re-constituted annually on June 30, based on prices and available shares outstanding as of

the preceding May 31. New index components are added only as part of the annual re-constitution, after which, should a stock be removed from an index for any reason, it cannot be replaced until the next re-constitution.

Although CBOE is not involved in the maintenance of the Russell 2000, the Exchange represents that it will monitor the Russell 2000 on a quarterly basis and will notify the Staff in the Division by filing a rule change pursuant to Rule 19b-4 if: (1) The number of securities in the index drops by ¼rd or more; (2) 10% or more of the weight of the index is represented by component securities having a market value of less than \$75 million; (3) less than 80% of the weight of the index is represented by component securities that are eligible for options trading pursuant to CBOE Rule 5.3; (4) 10% or more of the weight of the index is represented by component securities trading less than 20,000 shares per day; or (5) the largest component security accounts for more than 15% of the weight of each Index or the largest five components in the aggregate account for more than 50% of the weight of the Index. These are, generally, similar maintenance procedures that were adopted by CBOE for the monitoring of several other Russell Indexes.<sup>14</sup>

*Surveillance.* Because the index underlying the reduced-value options remains unchanged, the Exchange represents that CBOE’s surveillance procedures are adequate to monitor the trading in reduced-value options and LEAPS on the Russell 2000. Further, the Exchange shall have complete access to the information regarding the trading activity of the underlying securities.

*Margin.* The Russell 2000 is a “broad-based index” and, under CBOE margin rules, the margin requirement for a short put or call on each respective reduced-value Russell 2000 option contract shall be 100% of the current market value of the contract, plus up to 15% of the respective underlying index value.<sup>15</sup> More specifically, for purchases of puts or calls with more than 9 months until expiration, customers must deposit and continue to maintain 75% of the total cost of the option’s current market value.<sup>16</sup> When the time until expiration reaches 9 months, the option no longer has value for margin purposes.<sup>17</sup> Purchases of puts or calls with 9 months or less until expiration must be paid for

<sup>13</sup> See Securities Exchange Act Release No. 43000 (June 30, 2000), 65 FR 42409 (July 10, 2000) (notice of filing and immediate effectiveness of rule change SR-CBOE-00-15) (proposing the listing of options on reduced-value versions of the Nasdaq 100 Stock Index).

<sup>14</sup> See CBOE Rule 12.3(c)(5)(A).

<sup>15</sup> See CBOE Rule 12.3(c)(4)(B).

<sup>16</sup> See *id.*

in full. Writers of uncovered puts or calls must deposit and continue to maintain 100% of the option proceeds plus 15% of the aggregate contract value (current index level  $\times \$100$ ) minus the amount, if any, by which the option is out-of-the-money, subject to a minimum for calls of option proceeds plus 10% of the aggregate contract value and a minimum for puts of option proceeds plus 10% of the aggregate exercise price amount.<sup>18</sup>

*Other Exchange Rules Applicable.* Except as modified herein, the Rules in Chapter XXIV will govern the trading of options on the aforementioned Russell Indexes on the Exchange. Additionally, in accordance with CBOE Rule 24A.4(b) (Special Terms for FLEX Index Options), CBOE reserves the right to approve and open for trading FLEX options on the reduced-value versions of the Russell 2000, and, in accordance with Rule 24A.7(a)(i), because the Russell 2000 is a broad-based index, there shall be no position or exercise limits for these FLEX index options. Finally, CBOE affirms that it possesses the necessary systems capacity to support new series that would result from the introduction of the reduced-value Russell Index options, including LEAPS. The Exchange will consider the potential impact on system capacity before listing FLEX reduced-value options on the Russell 2000. The Exchange also, concurrent with this the submission of this rule filing, provided the Division with a letter that describes the potential impact that the introduction of these options will have on quoting capacity.

## 2. Statutory Basis

CBOE believes that the proposed rule change is consistent with Section 6 of the Act,<sup>19</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>20</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

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

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

<sup>18</sup> For calculating maintenance margin, the option's current market value, as opposed to the total cost/option proceeds method, must be used. Additional margin may be required pursuant to Exchange Rule 12.10.

<sup>19</sup> 15 U.S.C. 78f.

<sup>20</sup> 15 U.S.C. 78f(b)(5).

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

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

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

Because the foregoing proposed rule change does not:

- (i) Significantly affect the protection of investors or the public interest;
- (ii) impose any significant burden on competition; and

(iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>21</sup> and Rule 19b-4(f)(6) thereunder.<sup>22</sup> In addition, the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of the filing of the proposed rule change, as required by Rule 19b-4(f)(6). 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.<sup>23</sup>

CBOE asked the Commission to waive the 30-day operative delay contained in Rule 19b-4(f)(6)(iii) under the Act.<sup>24</sup> The Commission believes that such waiver is consistent with the protection of investors and the public interest, since the proposed rule change merely allows CBOE to begin listing and trading additional versions of the Russell 2000 index option, which has previously been approved by the Commission. The Commission does not believe that the filing raises any new regulatory issues. Therefore, the Commission hereby waives the 30-day operative delay.<sup>25</sup>

<sup>21</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>22</sup> 17 CFR 240.19b-4(f)(6).

<sup>23</sup> For purposes of calculating the 60-day abrogation period, the Commission considers the proposal to have been filed on February 14, 2005, the date the CBOE filed Amendment No. 2.

<sup>24</sup> 17 CFR 240.19b-4(f)(6)(iii).

<sup>25</sup> For purposes only of waiving the 30-day pre-operative period, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

## IV. 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. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2004-89 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-89. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2004-89 and should be submitted on or before March 18, 2005.

<sup>26</sup> 17 CFR 200.30-3(a)(12).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>26</sup>

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

[FR Doc. E5-770 Filed 2-24-05; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51231; File No. SR-NASD-2004-089]

### **Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to Proposed Amendments To Require Limit Order Protection and To Expand the Application of Manning Obligations to Exchange-Listed Securities**

February 18, 2005.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that June 9, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in items I, II, and III below, which items have been prepared by the NASD. On November 2, 2004, the NASD filed 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, as amended, from interested persons.

#### **I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change**

NASD is proposing to require providing price improvement to customer limit orders under certain circumstances and to expand the application of NASD IM-2110-2 to exchange-listed securities.

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

\* \* \* \* \*

#### **IM-2110-2. Trading Ahead of Customer Limit Order**

##### (a) General Applications

To continue to ensure investor protection and enhance market quality,

NASD’s [the Association’s] Board of Governors is issuing an interpretation to NASD [the] Rules [of the Association] dealing with member firms’ treatment of their customer limit orders in Nasdaq and exchange-listed securities. This interpretation, which is applicable from 9:30 to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not “trade ahead” of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. [Such orders shall be protected from executions at prices that are superior but not equal to that of the limit order.] In the interests of investor protection, NASD [the Association] is eliminating the so-called disclosure “safe harbor” previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm (1).

(1) For purposes of [the pilot program expanding] the operation of certain Nasdaq transaction and quotation reporting systems and facilities [in SR-NASD-99-57] during the period from 4 p.m. to 6:30 p.m. Eastern Time. If a customer does not formally assent (“opt-in”) to processing of [their] the customer’s limit order(s) during the extended hours period commencing after the normal close of the Nasdaq market, limit order protection will not apply to that customer’s order(s).

##### Interpretation

The following interpretation of Rule 2110 has been approved by the Board:

A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq or exchange-listed security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer’s limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that[, until September 1, 1995, customer limit orders in excess of 1,000 shares received from another member firm shall be protected from the market maker’s executions at prices that are superior but not equal to that of the limit order, and provided further, that] a member firm may negotiate specific terms and conditions applicable to the

acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an “institutional account” as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than \$100,000 in value. *In the event that a member acting as market maker trades ahead of an unexecuted customer limit order at a price that is better than the unexecuted limit order, such member is required to execute the limit order at the price received by the member or better.* Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, NASD [the Association] wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. NASD [The Association] believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer’s order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm’s market-making capacity does not occur. [For purposes of this interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer’s limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market-making unit may not trade ahead of that customer’s limit order.]

As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis when holding an unexecuted limit order for a Nasdaq security trading in fractions, and not be required to execute the held limit order, is as follows:

- If actual spread is greater than  $\frac{1}{16}$  of a point, a firm must price improve an incoming order by at least a  $\frac{1}{16}$ . For stocks priced under \$10[,] (which are quoted in  $\frac{1}{32}$  increments), the firm must price improve by at least  $\frac{1}{64}$ .

- If actual spread is the minimum quotation increment, a firm must price

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

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

<sup>3</sup> Amendment No. 1 to SR-NASD-2004-089 replaces and supercedes the NASD’s original 19b-4 filing in its entirety.