

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

Purpose

The Exchange is proposing to change the minimum value size for opening transactions (other than FLEX Quotes responsive to a FLEX Request for Quotes) in any FLEX Equity Option series in which there is no open interest at the time the Request for Quotes is submitted. Currently, CBOE Rule 24A.4 states that the minimum value size for these opening transactions shall be 250 contracts. The Exchange is proposing to change this rule such that the minimum value size for these transactions shall be the lesser of 250 contracts or the number of contracts overlying \$1 million of the underlying securities.

The Exchange is proposing this change because it believes the current rule is unduly restrictive. The rule was originally put in place in to limit participation in FLEX Equity options to sophisticated, high net worth individuals. However, the Exchange believes that limiting participation in FLEX Equity Options based solely on the number of contracts purchased may diminish liquidity and trading interest in FLEX Equity Options for higher priced equities. The Exchange believes the value of the securities underlying the FLEX Equity Options is an equally valid restraint as the number of contracts and if set at the right limit can also prevent the participation of investors who do not have adequate resources. In fact, the limitation on the minimum value size for opening transactions in FLEX Index Options is tied to the same type of standard, the underlying equivalent value.³ The Exchange believes the number of contracts overlying \$1 million in underlying securities is adequate to provide the requisite amount of investor protection. An opening transaction in a FLEX Equity series on a stock priced at \$40.01 or more would reach this \$1 million limit before it would reach the contract size limit, *i.e.*, 250 contracts times the multiplier (100) times the stock price (\$40.01) totals \$1,000,250 million in underlying value.⁴ It should be noted that, currently, an investor can purchase 250 contracts in a FLEX Equity series on low priced stocks, meeting the

³ The term "underlying equivalent value" is defined in CBOE Rule 24A.1(r) for FLEX Index options, but it is not a defined term for FLEX Equity options.

⁴ Example amended per conversation between Gail Marshall-Smith, Division of Market Regulation, SEC, and Tim Thompson, CBOE, dated June 15, 1998.

minimum requirement without investing a minimum of \$1 million. For example, a purchase of FLEX Equity Options overlying a \$10 stock is permitted although the underlying value for the Options would be \$250,000, *i.e.*, 250 contracts times the multiplier (100) times the stock price (\$10).

Statutory Basis

The Exchange believes the proposed rule change is consistent with and furthers the objectives of Section 6(b)(5) of the Act⁵ by facilitating transactions in securities, removing impediments to and perfecting the mechanism of a free and open market in securities and otherwise serving to protect investors and the public interest. The Exchange believes that the proposal maintains the current investor protection principles while providing more investors an opportunity to trade FLEX Equity Options.

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. 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 proposed rule change 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. 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 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 principle office of the CBOE. All submissions should refer to the file number SR-CBOE-98-21 and should be submitted by August 13, 1998.

For the Commission, by the Division of Market Regulation, pursuant to the delegated authority.⁶

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40215; File No. SR-CHX-96-21]

Self-Regulatory Organizations; Chicago Stock Exchange, Incorporated; Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change Relating to "Stopped" Orders

July 15, 1998.

I. Introduction

On July 22, 1996, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt a rule relating to the entry and execution of stop orders and to clarify its rules relating to stopped orders. On August 27, 1996, the CHX submitted to the Commission Amendment No. 1 to

⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

⁵ 15 U.S.C. 78f(b)(5).

the proposed rule change,³ on February 19, 1998, the CHX submitted to the Commission No. 2 to the proposed rule change.⁴

On September 12, 1996, the proposed rule change, and Amendment No. 1 thereto, were published for comment in the **Federal Register**.⁵ No comments were received on the proposal. This order approved the proposal, as amended.

II. Description of the Proposal

The practice of stopping stock refers to a guarantee by a specialist that an order received by the specialist will be executed at no worse a price than the price agreed upon when the order was received, with the understanding that the order may receive a better price.

CHX Art. XX, Rule 28 sets forth the obligations of a CHX specialist with regard to orders that he or she has stopped. The Exchange is proposing to amend this rule to clarify that it pertains to orders that are stopped, not stop orders.⁶ Moreover, the Exchange is proposing to amend CHX Art. XX, Rules 28 and 37(a)(6) to place a limitation on the guarantee a specialist may provide to an order that is stopped. Specifically, the proposal provides such a guarantee shall in no event be greater than the greater of the size disseminated on either the primary market or the Exchange at the time the order was stopped. The Exchange maintains that this is consistent with the execution guarantee on orders that are subject to the BEST System that are not stopped, which are guaranteed an execution based on the lesser of the size displayed in the primary market or 2099 shares.⁷

III. Discussion

The Commission finds that the proposed rule change is consistent with

³ See Letter from David T. Rusoff, Attorney, Foley & Lardner, to Jon E. Kroeper, Attorney, SEC, dated August 27, 1996 ("Amendment No. 1").

⁴ See Letter from David T. Rusoff, Attorney, Foley & Lardner, to Michael Walinskas, Senior Special Counsel, SEC, dated February 18, 1998 ("Amendment No. 2"). Amendment No. 2 narrows the scope of the proposal by withdrawing the portion of the proposal that would have defined a "stop" order.

⁵ See Securities Exchange Act Release No. 37644 (September 5, 1996), 61 FR 48184.

⁶ A stop order is an order designated as such by the customer that requires the specialist to buy (sell) a security once a specified price level has been reached.

⁷ See CHX Article XX, Rule 37. The Exchange's Guaranteed Execution System (BEST System) specifies certain conditions under which CHX specialists are required to accept and guarantee executions of market and limit orders from 100 up to and including 2099 shares in Dual Trading System issues. Dual Trading System issues are securities that are assigned to CHX specialists and listed on either the New York Stock Exchange or the American Stock Exchange.

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).⁸ In this regard, the Commission believes the proposal is consistent with the Section 6(b)(5) 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. Moreover, the Commission believes that the proposal is consistent with Section 11(b) of the Act⁹ in that the amendments to the stopping stock procedures do not provide discretion to a specialist in the handling of an order.

The Exchange's stopping stock procedures, located in CHX Art. XX, Rules 28 and 37(a), are intended primarily to allow a specialist to prevent a customer order in a Dual Trading System issue subject to the BEST System¹⁰ from being executed at the current primary market bid or offer if such an execution would be outside of the primary market range for the day (*i.e.*, establishing a new high or low price in the security for the day).¹¹ Under this stopping stock policy, the specialist is required to execute stopped stock based on the next primary market sale.¹²

The Exchange has proposed to revise the text of CHX Art. XX, Rule 28 to clarify that this rule relates to stopped

stock and not stop orders. The Commission believes that such a revision is appropriate in that it will rectify any ambiguity that currently exists with regard to the subject matter covered by this rule.¹³

More significantly, the Exchange is proposing to amend CHX Art. XX, Rules 28 and 37(a) to limit a specialist's guarantee of an order that is stopped at a particular price to the greater of the size displayed in the primary market for the security or by the Exchange when the stopped order is entered. Currently, the Exchange's rules do not impose a size limitation on the guarantee provided by the specialist to orders that are stopped. Therefore, a specialist must execute the full size of a stopped order based on the next primary transaction, even if such transaction is for a lesser number of shares than the stopped order.¹⁴

In contrast, the CHX's execution guarantee on an order subject to the BEST System that is not stopped is limited to the lesser of the size displayed in the primary market or 2099 shares. Accordingly, the Exchange maintains that by establishing a size limitation on the guarantee provided to a stopped order, such guarantees will be more consistent with the execution guarantee provided to orders subject to the BEST System that are not stopped. Under the proposal, the portion of a stopped order that is not executed as a result of the next primary market transaction will be executed in accordance with the prices of subsequent transactions on the primary market.¹⁵

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78k(b).

¹⁰ See *supra* note 7.

¹¹ For example, assume the market in ABC stock is 20-20¹/₄; 5000 shares bid and offered and that the execution of an incoming buy market order for 500 shares at 20¹/₄ would be higher than the range in which the stock traded on the primary market during that trading day. A CHX specialist would stop such at 20¹/₄ and change his or her quote to 20¹/₁₆-20¹/₄; 500 bid and 5000 offered to reflect the stopped order. If the next sale on the primary market is for 500 shares at 20¹/₈, the Exchange's existing general policy regarding stopping stock would require the specialist to execute the stopped order at 20¹/₈. Alternatively, if the next primary market sale is at 20¹/₄, the stopped order will be executed at 20¹/₄. In minimum variation markets, the CHX rules permit a specialist to delay execution of stopped stock in minimum variation markets until a volume equal to the pre-existing volume ahead of the stopped order prints in the primary market. Specifically, the specialist is required to execute stopped orders in such markets after (1) a transaction takes place on the primary market at the bid (offer) or lower (higher) for a stopped sell (buy) order or (2) the displayed CHX share volume at the offer (bid) has been exhausted. See Interpretation and Policy .03 to CHX Rules, Art. XX, Rule 37; Securities Exchange Act Release No. 36401 (October 20, 1995), 60 FR 54893 (October 26, 1995) (File No. SR-CHX-95-10) (order permanently approving CHX pilot program for stopping stock in minimum variation markets) ("Pilot Program Permanent Approval Order").

¹² *Id.*

¹³ *E.g.*, although Art. XX, Rule 28 pertains to stopped orders, the paragraph heading to this rule currently reads "Liability for 'Stop' Orders."

¹⁴ For example, assume the primary market quote in ABC stock is the National Best Bid/Offer ("NBBO") at 20-20¹/₄; 1000 shares bid and offered, the CHX quote is 19⁷/₈-20¹/₄; 200 shares bid and offered, and the high sale for the day in the primary market is 20¹/₈. A CHX specialist would stop an order to buy 1500 shares at 20¹/₄ and change his or her bid to 20¹/₈ for 1500 shares to reflect the stopped order. If the next sale on the primary market is for 500 shares at 20¹/₄, current CHX policy would require the specialist to execute all 1500 shares of the stopped order at 20¹/₄.

¹⁵ For example, assume the primary market quote in ABC stock is the NBBO at 20-20¹/₄; 1000 shares bid and offered, the CHX quote is 19⁷/₈-20¹/₄; 200 shares bid and offered, and the high sale for the day in the primary market is 20¹/₈. A CHX specialist would stop a market order to buy 1500 shares at 20¹/₄ and change his or her bid to 20¹/₁₆ for 1500 shares to reflect the stopped order. If the next sale on the primary market is for 1000 shares at 20¹/₄ (regardless of whether the specialist is the buyer), the specialist would be obligated to execute 1000 shares of the stopped order at 20¹/₄. If the primary market quote then changes to 20¹/₈-20³/₈; 1000 shares bid and offered, and a transaction occurs on the primary market at 20³/₈ for 500 shares, then the remaining 500 shares of the order will be executed at 20³/₈.

The Commission recognizes the unintended consequences that can arise from the interplay between a regional exchange's price protection rules and its procedures for stopping stock. The Commission believes that the proposal is an acceptable means for the Exchange to accomplish the legitimate end of treating out-of-range and in-range orders in a more equivalent manner. The Commission also believes that the proposed rule change is appropriate in the context of current regional exchange market making practices. In this regard, the proposal will permit the Exchange to continue to reduce the likelihood of an out-of-range execution for orders entered on the CHX without obligating the specialist to execute more shares than may be available to the specialist on the primary market to offset its risk.¹⁶ Moreover, the Commission finds it significant that under the proposal CHX specialists will continue to offer the opportunity for price improvement to orders that are stopped to avoid an out-of-range execution, regardless of their size. In addition, the Commission believes that the Exchange's proposal is appropriate in that providing generally equivalent guarantee size limitations to stopped and non-stopped orders will allow for a more uniform treatment of such orders by CHX specialists and systems, thereby having the potential to facilitate the ability of CHX specialists to carry out their market making functions.

Further, The Commission believes that this provision is consistent with the prohibition in Section 11(b) of the Act¹⁷ against providing discretion to a specialist in the handling of an order. Section 11(b) was designed, in part, to address potential conflicts of interest that may arise as a result of the specialist's dual role as agent and principal in executing stock transactions. In particular, Congress intended to prevent specialists from unduly influencing market trends through their knowledge of market interest from the specialist's book and their handling of discretionary agency orders.¹⁸ The Commission has stated that, pursuant to Section 11(b), all orders other than market or limit orders are discretionary and therefore cannot be accepted by specialists.¹⁹

In this regard, the Commission has stated previously that it is appropriate

to treat a stopped order as equivalent to a limit order.²⁰ In reaching this conclusion, the Commission did not expressly consider the status of a stopped order under exchange rules that limit the guarantee of a stopped order by its size. Under such rules, a stopped order of a size exceeding the guarantee shares features of both a limit and market order. As with the typical stopped order, the guaranteed portion is executable at the guaranteed price or better, and is therefore akin to a limit order. The portion of the order that exceeds the size guarantee is subject to execution pursuant to the same requirements applied to market orders entered with CHX specialists.²¹ The Commission, therefore, believes that the requirements imposed on the specialist with regard to such orders provide sufficiently stringent guidelines to ensure that the specialist will implement the proposed rule change in a manner consistent with his market making duties and Section 11(b).

In conclusion, however, the Commission notes that the Exchange's adoption of a guarantee size limitation for stopped orders does not, in any way, modify a CHX specialist's best execution obligation to any stopped order that exceeds the size guarantee limitation.²²

The Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing of this amendment in the **Federal Register**. Amendment No. 2 narrows the scope of the proposal by withdrawing the portion of the proposal that would have defined a "stop" order. The Exchange represents that it is reconsidering how to better codify the Exchange's rules relating to

²⁰ See Pilot Program Permanent Approval Order, *supra* note 11. A limit order is an order to buy or sell a stated amount of a security at a specified price, or better if obtainable.

²¹ However, if the guaranteed portion is executed at a stop price that is the new high (low) for the day, and the primary market quote subsequently moves to the next higher (lower) trading increment, pursuant to CHX rules the unexpected portion will itself be stopped at that increment. In such instances this portion would itself appropriately be deemed equivalent to a limit order.

²² Moreover, the Commission's recently-released study on "preferencing" on national securities exchanges stated that the practice of stopping stock should be reconsidered in the context of minimum variation markets. See SEC, Report on the Practice of Preferencing Pursuant to Section 510(c) of the National Securities Markets Improvement Act of 1996 ("Preferencing Study") (1997). The Commission notes that nothing in this approval order should be interpreted as affecting the conclusions reached by the Commission in the Preferencing Study.

"stop" orders.²³ Granting accelerated approval to Amendment No. 2 will allow the Exchange to codify its procedures with respect to "stopped" orders immediately. The Commission notes that the original proposal was published for the full 21-day comment period and no comments were received by the Commission. Accordingly, the Commission believes there is good cause, consistent with Sections 6(b)(5) and 19(b)²⁴ of the Act, to approve Amendment No. 2 to the Exchange's proposal on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 to 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. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CHX-96-21 and should be submitted by August 13, 1998.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁵ that the proposed rule change (SR-CHX-96-21), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁶

Jonathan G. Katz,
Secretary.

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²³ Telephone conversation between David T. Rusoff, Attorney, Foley & Lardner and David Sieradzki, Attorney, Commission on July 15, 1998.

²⁴ 15 U.S.C. 78f(b)(5) and 15 U.S.C. 78s(b).

²⁵ 15 U.S.C. 78s(b)(2).

²⁶ 17 CFR 200.30-3(a)(12).

¹⁶ See *supra* note 15.

¹⁷ 15 U.S.C. 78k(b).

¹⁸ See H. Rep. No. 1383, 73d Cong. 2d Sess. 22, S. Rep. 792, 73d Cong. 2d Sess. 18 (1934).

¹⁹ See SEC, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2 (1963).