

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42696; File No. SR-CBOE-99-38]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to the Proposed Rule Change Amending Trade Processing Rules

April 18, 2000.

On July 13, 1999, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19(b)-4 thereunder,<sup>2</sup> a proposed rule change to amend the Exchange's trade processing rules. The proposed rule change was published for comment in the **Federal Register** on November 16, 1999.<sup>3</sup> The CBOE submitted Amendment No. 1<sup>4</sup> to the proposed rule change on December 28, 1999. The Commission received no comments on the proposal. This order approves the proposal, as amended.

#### I. Description of the Proposal

The CBOE states that the purpose of the proposed rule change is to update the Exchange's trade processing rules to incorporate changes that have been made to the Exchange's trade processing system over the last few years.

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

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

<sup>3</sup> See Exchange Act Release No. 42112 (Nov. 5, 1999), 64 FR 62238.

<sup>4</sup> See Letter from Timothy Thompson, Director, Regulatory Affairs, CBOE, to David Sieradzki, Special Counsel, Division of Market Regulation, Commission, dated December 23, 1999 ("Amendment No. 1"). Amendment No. 1 clarifies that the reporting obligations of Exchange Rule 6.51(a) are for public dissemination purposes while the reporting obligations of Exchange Rule 6.51(d) are for clearance purposes. Second, Amendment No. 1 revises Interpretation and Policy .01 to Exchange Rule 6.51 to clarify that members that do not use handhelds must report trades as promptly as possible regardless of the requirements of Exchange Rule 2.30 that permit trades to be reported over a longer time frame before fees are imposed automatically. Third, Amendment No. 1 changes the word "may" back to "shall" in Interpretation and Policy .01(c) to Exchange Rule 6.61 regarding the submission of unmatched trades to The Options Clearing Corporation. Fourth, Amendment No. 1 deletes the provision of Interpretation and Policy .01(d) to Exchange Rule 6.61 that states that the Exchange may establish a schedule of fines or refer violations to the Exchange's Business Conduct Committee. Finally, Amendment No. 1 changes the first reference to "Clearing Member" in Exchange Rule 6.60 to "Member" because all members are required under the proposed rule change to report trade information for clearing purposes.

According to the Exchange, one significant change that has occurred at the Exchange is the increasing use of market-maker handheld trading terminals. Market-maker handheld terminals are electronically linked to the Exchange's trade processing system and trade information is sent to the Exchange's trade processing system automatically when a trade is input onto the handheld terminal. Currently, more than 85% of market-maker trade input is done through market-maker handheld terminals. Market-makers that do not use handheld terminals must manually record their trade information on a trade card and submit a copy of the card to the member's clearing firm for inclusion into the Exchange's trade processing system.

The Exchange is proposing to change Exchange Rule 6.50 to require members to file with the Exchange trade information required by Rule 6.51(d) for each Exchange transaction for which the member is responsible. The Rule currently states that only Clearing Members are required to file the required trade information with the Exchange. The Exchange believes that with the use of handhelds much of the required trade information is already provided automatically by the market-maker members.

The Exchange is deleting the phrase "business day (the exact hours to be fixed by the Exchange)" under Exchange Rule 6.51(d), which describes when members are required to submit trade information because the Exchange no longer uses a scheduled batch process for processing trade information. Consequently, the Exchange no longer fixes the time by which trade information must be submitted. Currently, the Exchange processes trade information on a continuous real time basis as it receives input from handhelds and other electronic systems such as the Retail Automatic Execution System ("RAES")<sup>5</sup> and the Exchange's Order Routing System ("ORS")<sup>6</sup> throughout the trading day.

The Exchange is proposing to change Interpretation .01 to Rule 6.51 to require the buyer and seller in each transaction to immediately provide the transaction record to the member for whom the transaction was executed and/or the clearing member that will clear the transaction. Buyers and sellers who do

<sup>5</sup> RAES permits automatic execution of small public customer orders.

<sup>6</sup> ORS provides member firms with a method of efficiently delivering orders to CBOE's trading floor. Orders received by ORS are logged onto the ORS database and evaluated, based on volume and price, to determine their routing destination on the trading floor.

not use handheld terminals would be required to provide the transaction record as promptly as possible to the member for whom the transaction was executed and/or the clearing member that will report the trade. Currently, Interpretation .01 requires the buyer and seller to provide the transaction record within the time frames established by the Exchange. The Exchange believes that the widespread use of technology in trading allows for the information to be provided immediately. The provision of the information immediately will allow for more efficient trade checking on an intra-day basis.

The Exchange is adding a new Interpretation .03 to Exchange rule 6.51 to explicitly set forth the requirements for submitting trade information. These requirements are currently set forth in Exchange rule 2.30, which establishes fees for late trade submission. Members are required to submit the information immediately or as promptly as possible in accordance with interpretation .03 even if a longer time period is allowed before fees for delayed submission of trade information are assessed pursuant to Rule 2.30. The new interpretation sets forth the following procedures for reporting transactions pursuant to Rule 6.51(d): For trades executed via an electronic data storage medium, or electronic system, trade information shall be immediately submitted to the Exchange for trade matching and clearance. For trades not executed on an electronic data storage medium, or electronic system, trade information shall be immediately recorded on a card or ticket and submitted as soon as reasonably possible, but not later than the one hour maximum time period stated in rule 2.30.

The Exchange is amending rule 6.61 to provide that a member may receive either an Unmatched Trade Notification or an Unmatched Trade Report. An Unmatched Trade Notification is an electronic message sent to market-maker handheld users, whereas an Unmatched Trade Report is a written notice sent to all members and firms. Currently, under rule 6.61 a member only receives Unmatched Trade Reports. The Exchange is also proposing to amend Rule 6.61 to obligate members to reconcile all unmatched trades and advisory trades and to report all reconciliations to the Exchange "or the Clearing Member responsible for submission to the Exchange."

The Exchange is also proposing to amend Interpretation .01 to Rule 6.61 to require members and their representatives to make all reasonable efforts to resolve unmatched trades on trade day. Currently, Interpretation .01

states that members and their representatives must resolve unmatched trades from the previous day's trading no later than the opening of trading on the following business day. According to the Exchange, because of system enhancements, the Exchange and its members now have the tools to review trade activity on an intra-day basis. The Exchange believes that requiring reports to be reconciled on an intra-day basis can minimize potential losses to members who may have to take market action to correct an outtrade.

For trades that remain unmatched after trade day, the Exchange is proposing to amend paragraph (c) of Interpretation .01 to Rule 6.61 to change the time requirement for correcting these trades from the opening of trading on the next business day to fifteen minutes prior to the opening of trading on the next business day. This change will allow the involved parties to correct their positions and be prepared for trading sooner. The Exchange believes that by resolving the unmatched trade before the market in the underlying security opens, the parties will be in a better position to enter any necessary orders in the markets to adjust their positions where necessary.

In addition, the Exchange is adding new paragraph (a) of Interpretation .01 to Rule 6.61, which essentially is an updated version of what is now paragraph (a) of Interpretation .05 to rule 6.61. Currently, Interpretation .05 requires that a representative be available to resolve unmatched trades only for transactions in index options or in any class of options which will trade ex-dividend or ex-distribution the following day. New paragraph (a) of Interpretation .01 to Rule 6.61 will expand this requirement by stating that a representative must be available to reconcile unmatched trades for all options transactions on all trade dates.

The Exchange is also proposing to amend Rule 6.61, Interpretation .05(b) and (d) to expand the options classes which must comply with the requirement that members make reasonable efforts to detect and correct errors in carding or keying a trade and the provision that states that members who fail to comply with Rule 6.61 will be responsible for any liability resulting from an unmatched transaction that should have been matched. Currently, Interpretation .05(b) and (d) only apply to index options and any class of options which will trade ex-dividend or ex-distribution the following day. These provisions, as amended, will apply to all transactions in options.

Finally, the Exchange is proposing to amend Interpretation .05 to Exchange Rule 6.61 by revising the language to make it consistent with current practice. The Exchange has deleted references to First Pass and Second Pass. First Pass and Second Pass refer to the former practice of submitting trade information for trade processing in batches at different times during the day. The Exchange currently processes the trade information continually through the trade day.

## II. Discussion

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. In particular, the Commission finds that the proposed rule change meets the requirements of Section 6(b)(5) of the Act<sup>7</sup> which states that, among other things, the rules of an exchange must be designed to facilitate securities transactions and to remove impediments to and perfect the mechanism of a free and open market. Specifically, the Commission believes that given the increasing use of handheld terminals, requiring all members to report trade information, rather than just clearing members as currently required, will facilitate securities transactions by making the clearance and settlement process more efficient. As noted by the Exchange, the increasing use of handheld trading terminals has allowed certain trade information to be sent automatically at the time of the trade to the Exchange's trade processing system. Accordingly, the Commission believes changing CBOE rules to impose trade reporting obligations on all members, not just clearing members, reflects the reality of automation on the CBOE floor and imposes the trade reporting burden on those members actually reporting such information currently through handheld terminals.<sup>8</sup>

Under the new rules, buyers and sellers in each transaction using handheld terminals will be required to immediately provide the transaction information to the member for whom it was executed or clearing member clearing the transaction. The Commission recognizes, however, that not all members are using handheld terminals. Accordingly, under the

<sup>7</sup> 15 U.S.C. 78f(b)(5). In approving this rule change, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>8</sup> We note that the CBOE states in its filing the 85% of market-maker trade input is currently done through handheld terminals.

CBOE's new rules, buyers and sellers who do not use handheld terminals would be required to provide the transaction information as promptly as possible. The Commission believes that the proposed rule change adequately accommodates members who choose not to use handheld terminals by requiring them to report trade information as promptly as possible rather than immediately.

In addition, the Commission believes that, by requiring members to take all reasonable efforts to resolve unmatched trades on the day of the trade, rather than by the opening of trading on the following business day, the proposed rule change will minimize the potential loss to members who may have to take action to correct an outtrade. Similarly, the Commission believes that requiring all trades that remain unmatched after the trade day to be resolved at least fifteen minutes prior to the open of trading will enable involved parties to be better prepared for the open of trading and in a better position to enter any necessary orders in the markets to adjust their positions where necessary. The Commission further believes that requiring members to have a representative available to resolve unmatched trades for all options, rather than only index options and options that will trade ex-dividend or ex-distribution the following day, will help to ensure that all unmatched trades are resolved as quickly as possible. Moreover, the Commission believes that requiring members who fail to observe the procedures of Exchange rule 6.61 to be responsible for unmatched trades in all options that should have matched and requiring members to make reasonable efforts to detect and correct errors attributable to carding or keying a trade in all options<sup>9</sup> will also help to ensure that unmatched trades are resolved more quickly. Finally, the Commission believes that the proposed rule change, as a whole, recognizes and accommodates technological advances on the floor of the Exchange, and updates the CBOE rules to reflect these changes.

The Commission finds good cause to approve Amendment No. 1 to the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission notes that Amendment No. 1 merely makes certification clarifications to the proposed rule change and does not present any new regulatory issues.

<sup>9</sup> As noted above, these provisions previously applied only to index options and options trading ex-dividend or ex-distribution the following day.

Accordingly, the Commission finds that good cause exists, consistent with section 6(b)(5)<sup>10</sup> and 19(b)(2)<sup>11</sup> of the Act to accelerate approval of Amendment No. 1 to the proposed rule change.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1, including whether Amendment No. 1 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, in Washington, DC. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-99-38 and should be submitted by May 16, 2000.

### IV. Conclusion

*It Is Therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (SR-CBOE-99-38), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

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

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42693; File No. SR-CBOE-99-03]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to Option Exercise Procedures

April 17, 2000.

On January 20, 1999, the Chicago Board Options Exchange, Inc. ("CBOE" or the "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change 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> In its filing, CBOE proposes to amend Exchange Rules 4.16 and 11.1 relating to option exercise procedures for noncash-settled equity options and American-style, cash-settled index options, as well as to reflect in an Exercise Regulatory Circular the proposed changes to American-style, cash-settled index options, and a change approved in a prior Commission Order relating to those options.<sup>3</sup> On May 10, 1999, the Exchange submitted to the Commission Amendment No. 1 to the proposed rule change.<sup>4</sup> The proposed rule change and Amendment No. 1 were published for comment in the **Federal Register** on June 1, 1999.<sup>5</sup> The Commission received no comments on the proposal. This Order approves the proposed rule change as amended.

#### I. Description of the Proposal

##### *A. Exercise Procedures for American-Style, Cash-Settled Index Options After Certain Trading Halts and During a Trading Resumption That May Follow Such Trading Halts*

The CBOE proposes to modify its rules governing the exercise of American-style, cash-settled index options during certain trading halts. In addition, if trading resumes following a trading halt (such as by closing

rotation), the Exchange proposes to permit exercises to occur during the resumption of trading and for five minutes after the close of the resumption of trading. In particular, the Exchange proposes to modify CBOE Rules 11.1 and 4.16 to permit the exercise of American-style, cash-settled index options during a trading halt that occurs at or after 3:00 p.m. (Central Time).<sup>6</sup> A number of index options are traded on the Exchange from 8:30 a.m. To 3:15 p.m. (CT),<sup>7</sup> whereas the markets for the equity securities underlying those index options generally close for trading by 3:00 p.m. (CT). CBOE Rule 11.1 governs the exercise of option contracts, including index option contracts, and provides that Exchange members will follow the procedures of the Options Clearing Corporation ("OCC"), as well as those of the Exchange, when exercising option contracts. CBOE Rule 4.16 governs other restrictions on options transactions and exercises. Under CBOE Rule 11.1.05<sup>8</sup> and CBOE Rule 4.16(b), exercises of cash-settled index options are prohibited whenever trading in such options is delayed, halted or suspended, unless otherwise determined by the Exchange's President or his designee.<sup>9</sup> The Exchange has long noted that one of the distinctive characteristics of a cash-settled option is that its exercise is functionally equivalent to trading out of the long position, and, conversely, the assignment of a short option eliminates

<sup>6</sup> Currently, the Exchange trades only one type of standardized American-style, cash-settled index option contract, Standard & Poor's 100 index options ("OEX index options").

<sup>7</sup> CBOE Rule 24.6, *Days and Hours of Business*.

<sup>8</sup> The Exchange is proposing to move the text of CBOE Rule 11.1.05, which relates to the exercise of American-style, cash-settled index options, to proposed CBOE Rule 11.1.03(h) for ease of reference for Exchange members.

<sup>9</sup> The Exchange is also proposing to reflect the Commission's 1999 approved rule changes to CBOE Rule 11.1.05 and CBOE Rule 4.16(b) in an Exercise Regulatory Circular. In 1999, the Commission approved rule amendments to CBOE Rule 11.1.05 and CBOE Rule 4.16(b), which state that with the exception of the last business day prior to expiration, exercises of cash-settled index options will be prohibited during any time when trading in such options is delayed, halted, or suspended, unless otherwise determined by the Exchange's President or his designee. The 1999 rule amendments also stated that, notwithstanding this prohibition, the exercise of a cash-settled index option may be processed and given effect in accordance with and subject to the rules of the OCC while trading in an option is delayed, halted, or suspended if it can be documented that the decision to exercise the option was made during allowable time frames prior to the delay, halt or suspension. The Commission approved these rule amendments in 1999, but the Exchange did not propose, at that time, to reflect those rule amendments in an Exercise Regulatory Circular. See Securities Exchange Act Release No. 40951 (January 15, 1999), 64 FR 4482 (January 28, 1999) (File No. SR-CBOE-98-33).

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

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

<sup>3</sup> The Exchange's Exercise Regulatory Circular sets forth procedures and requirements regarding the exercise of American-style, cash-settled index options. In 1998, the CBOE filed with the Commission the Exercise Regulatory Circular, See Securities Exchange Act Release No. 40334 (August 18, 1998), 63 FR 45275 (August 25, 1998) (File No. CBOE-98-34).

<sup>4</sup> See Letter from Arthur B. Reinstein, Counsel, CBOE, to Hong-anh Tran, Attorney, Division of Market Regulation ("Division"), SEC, dated May 10, 1999 ("Amendment No. 1").

<sup>5</sup> Securities Exchange Act Release No. 41435 (May 21, 1999), 64 FR 29370 (June 1, 1999) (File No. SR-CBOE-99-03).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

<sup>11</sup> 15 U.S.C. 78s(b)(2).

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).