

## SECOND FAIR ACT RELEASE 2002—Continued

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-46935; File No. SR-CBOE-2002-27]

**Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Change and Amendments No. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. Relating to Permanent Approval of the 100 Spoke RAES Wheel Pilot Program and Elimination of the "Vacation Penalty"**

December 2, 2002.

**I. Introduction**

On May 24, 2002, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), 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> a proposal to amend its rules to eliminate the pilot program and

make permanent the 100 Spoke RAES Wheel System. The CBOE further proposed to modify the calculation of the participation distribution for market makers participating on the 100 Spoke RAES Wheel by eliminating the "vacation penalty." On July 17, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On September 26, 2002, the Exchange filed Amendment No. 2 to the proposed rule change.<sup>4</sup> On October 17, 2002, the Commission published the proposed rule change and Amendments No. 1 and 2 in the **Federal Register**.<sup>5</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

**II. Description of the Proposal**

On May 25, 2000, the Commission approved, on a pilot basis, the Exchange's proposal to amend Rule 6.8

to provide the appropriate Floor Procedure Committee ("FPC") with a third choice for apportioning RAES trades among participating market makers, the 100 Spoke RAES Wheel.<sup>6</sup> In those classes where the 100 Spoke RAES Wheel is employed, the allocation of RAES trades to participating market makers is commensurate with the distribution of in-person agency market-maker trades for non-RAES trades in that class. The pilot program has been extended five times, most recently until November 28, 2002.<sup>7</sup>

<sup>6</sup> Securities Exchange Act Release No. 42824 (May 25, 2000), 65 FR 37442 (June 14, 2000). RAES is the Exchange's automatic execution system for public customer market or marketable limit orders of less than a certain size.

<sup>7</sup> Securities Exchange Act Release No. 46644 (October 10, 2002) (pilot program extended until November 28, 2002) (SR-CBOE-2002-60); Securities Exchange Act Release No. 46149 (June 28, 2002), 67 FR 45161 (July 8, 2002) (pilot program extended until September 28, 2002) (SR-CBOE-2002-34); Securities Exchange Act Release No. 45230 (January 3, 2002), 67 FR 1380 (January 10, 2002) (pilot program extended until June 28, 2002) (SR-CBOE-2001-68); Securities Exchange Act Release No. 44749 (August 28, 2001), 66 FR 46487 (September 5, 2001) (pilot program extended until December 28, 2001) (SR-CBOE-2001-47); Securities Exchange Act Release No. 44020 (February 28, 2001), 66 FR 13985 (March 8, 2001) (pilot program extended until August 28, 2001) (SR-CBOE-01-07).

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

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

<sup>3</sup> See Letter from Nancy L. Nielsen, Director of Arbitration and Assistant Secretary, CBOE, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated July 16, 2002 ("Amendment No. 1").

<sup>4</sup> See Letter from Madge M. Hamilton, Legal Division, CBOE, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated September 26, 2002 ("Amendment No. 2").

<sup>5</sup> See Securities Exchange Act Release No. 46683 (October 17, 2002), 67 FR 65384 (October 24, 2002).

Under the 100 Spoke RAES Wheel, RAES orders are assigned to market makers according to the percentage of their in-person agency contracts (excluding RAES contracts) traded in that class compared to the in-person agency contracts (excluding RAES contracts) of all of the market makers traded during the review period. Agency contracts are any contracts represented by an agent (booked orders and orders represented by brokers) and do not include contracts traded between market makers in person in the trading crowd. A particular market maker's entitlement will change based upon the percentage of agency contracts that market-maker traded in the review period. For example, if a particular market maker traded 10% of all the in-person agency contracts (excluding RAES contracts) of class ABC for a particular review period, then that market maker would be assigned 10% of the RAES contracts during the next trading period. The review period is determined by the appropriate FPC.

The RAES Wheel can be envisioned as having a number of spokes, each generally representing one percent of the total participation of all market makers in the class. Thus, a market maker generally will be assigned one spoke for each one percent of his or her market maker participation during the review period. If the spoke size is one and all market makers who traded in-person agency contracts in that option class during the review period are logged onto RAES, and no other market makers are logged on, the RAES Wheel would consist of 100 spokes, representing 100 percent of all market maker activity during the review period. The appropriate FPC may establish a larger spoke size. Setting the spoke size to five contracts, for example, would redefine the RAES Wheel for a particular option class as a Wheel of 500 contracts. A larger Wheel would mean the Wheel would not revolve as quickly through the logged on market makers, but a larger Wheel would not change the participation percentage of the individual market makers.

A wedge is the maximum number of spokes that may be consecutively assigned at any one time to a market maker during a rotation of the RAES Wheel. The purpose of the wedge is to break up the distribution of contracts into smaller groupings to reduce the exposure of any one market maker to market risk. If the size of the wedge is smaller than the number of spokes to which a particular market maker may be entitled based on his or her participation percentage, then that market maker would receive one or

more additional assignments during one revolution of the RAES Wheel. For example, in the case where one spoke is equal to one contract and the market maker's participation percentage is 15 percent (15 percent of 100 spokes) and the wedge size is ten, that market maker first would be assigned ten contracts on the RAES Wheel and then five contracts at a different place on the RAES during the same revolution of the RAES Wheel. The wedge size is variable at the discretion of the appropriate FPC and may be established at different levels for different classes, or at the same level for all classes.

In its filing, the Exchange represented that the 100 Spoke RAES Wheel has worked as anticipated by providing an efficient and effective alternative allocation method for assigning RAES trades. The Exchange further represented that, in those classes where the 100 Spoke RAES Wheel is employed, the distribution of RAES trades is essentially identical to the distribution of in-person agency market maker trades on non-RAES trades in that class during the relevant review period.

The Exchange also clarified the calculation of the participation distribution for market makers participating on the 100 Spoke RAES Wheel.<sup>8</sup> Specifically, the applicable review period would be adjusted to account for vacations by market makers. CBOE indicated that without this revision, if a market maker takes even a single trading day off over the two-week review period, the market maker is allocated a number of spokes that is less than the market-maker's average daily percentage of the trading volume, resulting in a "vacation penalty." Thus, rather than a maximum review period of two weeks, as provided in the current rule, the review period will be a maximum of 10 trading days, *i.e.*, last ten days in which the market maker had trading activity, subject to the condition that the review period cannot extend back more than 30 calendar days (in order to assure that the review period is not based on stale activity). Under the proposed rule, the trading days within the review period may be non-consecutive trading days, and the percentage allocation will be calculated at the conclusion of each trading day and will be applied to the 100 Spoke RAES Wheel distribution on the following trading day.

Further, CBOE explained that, in calculating the review period, the 10 trading days used to compute one market maker's RAES participation

distribution may be a different 10 trading days than another market maker signed onto RAES in the same trading crowd, and that the 10-day review periods of individual market makers may overlap.<sup>9</sup> In addition, CBOE clarified that the individual market makers have no discretion over which 10 trading days will be used in the calculation. The proposed rule change permits the appropriate FPC to set a review period not to exceed 10 trading days.<sup>10</sup> Once the appropriate FPC has set the number of days to be used in the calculation of the market maker's participation distribution, the Exchange looks back that number of trading days to calculate each market maker's participation right.

CBOE further noted that, under the proposed rule, the Exchange will conduct the calculation for the market maker participation distribution at the conclusion of each trading day and apply the market makers' RAES participation distribution to the following trading day. CBOE further explained that, since the calculation of the participation distribution is done at the end of each trading day, the 10 day review period for each market maker will be done on a rolling basis, *i.e.*, each time the calculation is conducted, the non-RAES agency trading volume for the current day, if any, is added to the 10 day review period, and the non-RAES agency trading volume for the oldest day used for the previous day's calculation is deleted. According to CBOE, this calculation encourages market makers to actively trade every day, since each day's trading activity will have an effect on the market maker's RAES participation distribution for the next trading day.<sup>11</sup> Finally,

<sup>9</sup> See Amendment No. 2, *supra* n. 4. As noted above, the review period of a maximum of 10 trading days (*i.e.*, the last ten days in which the market maker had trading activity) cannot extend back more than 30 calendar days.

<sup>10</sup> The Exchange represents that under the proposed rule change, as amended, all market makers' review periods will be of equal size, regardless of whether the Exchange may look at different underlying time periods to ascertain the most recent days of trading activity for a specific market maker. Telephone conference among Madge Hamilton, Legal Division, CBOE, Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, and Geoffrey Pemble, Special Counsel, Division of Market Regulation, Commission (November 26, 2002).

<sup>11</sup> Any market maker that logs on the system during a particular review period will be guaranteed to receive an entitlement during that review period of no less than 1 percent of RAES contracts, or one "spoke." The minimum entitlement applies to any market maker in a particular option class who logs on RAES during a given review period. Thus, new market makers who have not yet had time to acquire market share on the trading floor will be allocated a single spoke if

<sup>8</sup> See Amendment No. 1, *supra* n. 3.

CBOE noted the formula for determining market maker participation percentage on the 100 Spoke RAES Wheel. CBOE explained that in order to calculate a market maker's participation percentage, the "non-RAES agency trading volume" for a given market maker is divided by the "total volume," *i.e.*, the sum of the volume of the non-RAES agency trades for all traders in a particular options class (which is determined by adding together the trading volume for each market maker and DPM during his or her relevant review period).

### III. Discussion

After careful review, the Commission finds that implementation of the proposed rule change, as amended, is consistent with the requirements of Section 6 of the Act<sup>12</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>13</sup> Specifically, the Commission believes that the proposal, as amended, is consistent with Sections 6(b)(5) and 6(b)(8) of the Act.<sup>14</sup> Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest.<sup>15</sup> Section 6(b)(5) also requires that those rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 6(b)(8) of the Act requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

As the Commission stated in its original approval order for the 100 Spoke RAES Wheel as a pilot program, the Commission believes that CBOE's implementation of the 100 Spoke RAES Wheel system as a pilot program was an important step forward, as it rewarded those market makers who consistently

execute a greater portion of agency orders in the trading crowd, rather than randomly assigning contracts to all market makers logged on RAES. Although the 100 Spoke RAES Wheel does not reward a market maker for improving the Exchange's displayed quotation, it does reward the market maker for providing liquidity to orders in the trading crowd by linking the market maker's percentage of RAES contracts to the percentage of agency contracts it executed in the trading crowd.

Unlike the two means of allocation that were used exclusively prior to the 100 Spoke RAES Wheel pilot program, under which the size of the order assigned to a particular market maker is determined randomly,<sup>16</sup> the 100 Spoke RAES Wheel more closely allocates the percentage of contracts that a particular market maker can receive on a single revolution of the Wheel to the percentage of in-person agency contacts (excluding RAES contracts) traded on CBOE by that market maker. With the 100 Spoke RAES Wheel, market makers have a greater incentive to compete effectively for orders in the crowd, and this, in turn, should benefit investors and promote the public interest.

The Commission reiterates that implementation of the 100 Spoke RAES Wheel will have no effect on the prices offered to customers. Under CBOE Rule 6.8(d)(i), RAES automatically provides to each retail customer order its execution price, generally determined by the prevailing market quote at the time of the order's entry into the system. The 100 Spoke RAES Wheel merely provides for a different contract allocation system than currently exists for automatic execution of small retail orders.

The proposed rule change also will eliminate the "vacation penalty" that resulted under the original rule when a market maker was absent for one or more days. Under the proposed rule change, as amended, the review period will be the period not in excess of 10 trading days, *i.e.*, last ten days in which the market maker had trading activity, subject to the condition that the review period cannot extend back more than 30 calendar days (in order to assure that the review period is not based on stale activity). In addition, the Commission notes that under the proposal, all market maker's review periods will be of equal size, regardless of whether the Exchange may look at different underlying time periods to ascertain the most recent

days of trading activity for a specific market maker. The Commission finds that these changes relating to the "vacation penalty" are consistent with the Act.

### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>17</sup> that the proposed rule change, as amended (SR-CBOE-2002-27) is approved on a permanent basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46932; File No. SR-CHX-2002-34]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Stock Exchange, Inc. Relating to the Trading of Nasdaq/NM Securities

November 29, 2002.

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 on October 25, 2002, the Chicago Stock Exchange, Inc. ("CHX" or "Exchange") 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 Exchange. 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 has requested a one-year extension of the pilot program relating to the trading of Nasdaq/NM securities on the Exchange. Specifically, the pilot program amended Article XX, Rule 37 and Article XX, Rule 43 of the Exchange's rules. The current pilot expired on November 1, 2002. The Exchange proposes that the pilot remain in effect on a pilot basis through November 1, 2003. The text of the proposed rule change is available at the

they log on RAES during the first review period they traded that class on the Exchange floor. Telephone conference among Madge Hamilton, Legal Division, CBOE, Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, and Geoffrey Pemble, Special Counsel, Division of Market Regulation, Commission (November 26, 2002).

<sup>12</sup> 15 U.S.C. 78f.

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> 15 U.S.C. 78f(b)(5) and (b)(8).

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

<sup>16</sup> Under Variable RAES, the market maker has some flexibility in limiting the extent of its exposure during each revolution of the Wheel.

<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</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.