

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43004; File No. SR-CBOE-98-54]

Self Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving a Proposed Rule Change and Amendment No. 1 to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2, 3, 4, 5 and 6 to the Proposed Rule Change Relating to Designated Primary Market Makers

June 30, 2000.

I. Introduction

On December 22, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" 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 update and reorganize its rules concerning designated primary market makers ("DPMs"). On February 18, 1999, the Exchange submitted Amendment No. 1 to the proposed rule change.³ The proposed rule change, as amended by Amendment No. 1, was published in the **Federal Register** on May 3, 1999.⁴

On May 11, 1999, the Exchange submitted Amendment No. 2 to the proposed rule change.⁵ On September 29, 1999, the Exchange submitted Amendment No. 3 to the proposed rule change.⁶ On December 21, 1999, the

Exchange submitted Amendment No. 4 to the proposed rule change.⁷ On February 23, 2000, the Exchange submitted Amendment No. 5 to the proposed rule change.⁸ Finally, on May 25, 2000, the Exchange submitted Amendment No. 6 to the proposed rule change.⁹

⁷ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly Riley, Attorney, Division, SEC, dated December 16, 1999 ("Amendment No. 4"). In Amendment No. 4, the Exchange proposes four changes to the proposed rule change. First, Amendment No. 4 proposed subparagraph (a)(viii) to proposed Rule 8.85 to provide that a DPM shall not initiate a transaction for its own account that would result in putting into effect any stop or stop limit order, which the DPM represents as agent, unless approved by a Floor Official and guaranteed by the DPM that the stop or stop limit order will be executed at the same price as the electing transaction.

Second, Amendment No. 4 deletes the portion of proposed Rule 8.85(b) that granted the MTS Committee the discretion to authorize a DPM to represent discretionary orders in unusual circumstances.

Third, Amendment No. 4 revises the Guidelines for Exemptive Relief under proposed Rule 8.91(e), which provides that the guidelines may be supplemented or modified by the Exchange in individual cases when the Exchange deems it appropriate. The provision would be amended to better define the Exchange's discretion to be limited to only allow the Exchange to supplement the guidelines in a manner that is consistent with the intent of the original requirements. *But see* Amendment No. 6 *infra*, note 9.

Fourth, Amendment No. 4 deletes the phrase "approve an interim DPM" and replaced it with "approve a DPM on an interim basis" in proposed Rule 8.83(f)(i), to clarify that a DPM appointed on an interim basis is subject to all of the DPM obligations.

⁸ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly Riley, Attorney, Division, SEC, dated February 17, 2000 ("Amendment No. 5"). In Amendment No. 5, the CBOE confirms that any changes to the DPM financial guidelines proposed by the MTS Committee must be submitted to the Commission, pursuant to SEC Rule 19b-4.

⁹ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly Riley, Attorney, Division, SEC, dated May 24, 2000 ("Amendment No. 6"). In Amendment No. 6, the Exchange proposes three changes to the rule filing. First, the Exchange proposes to add language to proposed Rule 8.85 (a)(viii) to make it consistent with the current language of CBOE Rule 8.80(c)(7).

Second, the Exchange proposes to delete paragraph (c)(iii) of proposed Rule 8.85 and adds language addressing the same issue to proposed rule 8.88. Therefore, proposed Rule 8.88 now states that the review of a DPM's operations and performance shall include, among other things, an evaluation of the extent to which a DPM has satisfied its obligations under proposed Rule 8.85 and has otherwise acted in ways reasonably designed to make the Exchange competitive with other markets that trade the same options allocated to the DPM, taking into account the Exchange's market share.

Third, the Exchange proposed to delete the proposed provision granting discretion to the Exchange under the Guidelines for Exemptive Relief under proposed Rule 8.91(e). As amended, the Exchange proposes to allow DPMs and members affiliated with DPMs to structure their corporate organizations in a manner so as to create a functional separation between the DPM and the

The Commission received two comment letters on the proposal.¹⁰ This order approves the proposed rule change, as amended by Amendment No. 1, and approves Amendment Nos. 2, 3, 4, 5, and 6 to the proposed rule change on an accelerated basis. The Commission is also soliciting comment on Amendment Nos. 2, 3, 4, 5 and 6 to the proposed rule change from interested persons.

II. Background

The Exchange's DPM program began as a pilot program in 1987 with 4 DPMs that were allocated a total of 11 equity option classes. In 1994, the Commission approved the DPM program on a permanent basis.¹¹ Since its introduction, the DPM program has grown significantly. In June 1999, the members of the Exchange voted to expand the DPM program floor-wide to all equity options classes, as well as specified index options and structured products. According to the Exchange, currently there are 58 DPMs that have been allocated over 1400 options products.

Since its inception, the Exchange has developed procedures for implementing the rule provisions that govern the program. Currently, CBOE Rules 8.80 and 8.81 govern the DPM program. In this rule filing, the Exchange seeks to update these DPM rules to incorporate the various procedures that have been implemented pursuant to CBOE Rules 8.80 and 8.81 and to incorporate various proposed changes. In addition, the Exchange proposes to reorganize the rules by creating 12 separate rules that each address the 12 primary aspects of the DPM program.¹²

affiliate, instead of the current requirement of separate and distinct organizations. All of the other requirements under the guidelines, however, remain intact.

Finally, in Amendment No. 6, the Exchange clarifies that any changes to the formula for determining the participation entitlement, pursuant to proposed Rule 8.87, must be submitted to the Commission, pursuant to SEC Rule 19b-4.

¹⁰ Letter from James I. Gelbort, to Jonathan G. Katz, Secretary, SEC, dated May 21, 1999; letter from John L. Rushlie, to Kelly Riley, Attorney, Division, received on November 19, 1999.

¹¹ Securities Exchange Act Release No. 34999 (November 22, 1994), 59 FR 61361 (November 30, 1994) (File No. SR-CBOE-94-36).

¹² The Exchange filed a substantially similar proposed rule change with the Commission in 1998. *See* Securities Exchange Act Release No. 40041 (May 28, 1998), 63 FR 30525 (June 4, 1998) ("Original Proposal"). After the Original Proposal was submitted, however, the Exchange received a member petition concerning the transfer of DPM appointments. As a result of the member petition, the CBOE withdrew the Original Proposal. After the CBOE withdrew the Original Proposal, it engaged its members in a dialogue about DPM transferability by, among other things, holding membership meetings. The CBOE Board of Directors re-approved

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly McCormick, Attorney, Division of Market Regulation ("Division"), SEC, dated February 11, 1999 ("Amendment No. 1").

⁴ Securities Exchange Act Release No. 41325 (April 22, 1999), 64 FR 23691.

⁵ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly McCormick, Attorney, Division, SEC, dated May 10, 1999 ("Amendment No. 2"). In Amendment No. 2, the CBOE made non-substantive, grammatical changes to the proposed rule change.

⁶ Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly Riley, Attorney, Division, SEC, dated September 28, 1999 ("Amendment No. 3"). In Amendment No. 3, the Exchange proposed changes to propose Rule 8.82 regarding election procedures. These changes were made to conform proposed Rule 8.82 to changes proposed to be made to the Exchange's constitution. Specifically, Amendment No. 3 would change the date by which member petitions for the election of members of the Modified Trading System ("MTS") Committee must be submitted and clarifies that petitions must be signed by 100 voting members. *See* Securities Exchange Act Release No. 42026 (October 18, 1999), 64 FR 57499 (October 25, 1999) (SR-CBOE-99-43).

III. Description of the Proposed Rule Change

A. Proposed Rule 8.80—DPM Defined

Proposed Rule 8.80 defines a DPM as a member organization that is approved by the Exchange to function as a market maker, floor broker, and order book official in allocated securities. Proposed Rule 8.80 also clarifies that the MTS Committee approves DPM appointments while the Exchange's Allocation Committee and Special Product Assignment Committee determines which securities will be allocated to each DPM.¹³

B. Proposed Rule 8.81—DPM Designees

Proposed Rule 8.81 sets forth the requirements applicable to DPM Designees. A DPM Designee is an individual approved by the MTS Committee to represent the DPM in its capacity as a DPM. Since a DPM, as defined in proposed Rule 8.80, must be a member organization, proposed Rule 8.81 provides that a DPM may only act through its DPM Designees.

C. Proposed Rule 8.82—MTS Committee

Proposed Rule 8.82 governs the composition of the MTS Committee. The proposal retains the current 11 members composition, which consists of the Vice-Chairman of the Exchange, the Chairman of the Market Performance Committee, four members whose primary business is as a market maker, two members whose primary business is as a market maker or as a DPM Designee, one member whose primary business is as a floor broker who is not associated with a member organization that conducts public customer business, and two persons associated with member organizations that conduct public customer business.

D. Proposed Rule 8.83—Approval To Act as a DPM

Proposed Rule 8.83 sets forth the criteria that may be considered by the MTS Committee when making DPM application decisions. Specifically, the MTS Committee may consider such factors as adequacy of capital, operational capacity, trading experience, regulatory history, and market performance. In addition, an applicant may present any other matter that it wishes the MTS Committee to consider in conjunction with the

approval decision. As with most decisions of the MTS Committee, any applicant not approved by the MTS Committee to act as a DPM may appeal that decision to the Exchange's Appeals Committee, pursuant to Chapter XIX of the Exchange's Rules. The appeal procedures provide the right to a formal Appeals Committee hearing concerning any approval decision, and the decision of the Appeals Committee may be appealed to the Board of Directors, pursuant to CBOE Rule 19.5.

E. Proposed Rule 8.84—Conditions on the Allocation of Securities To DPMs

Proposed Rule 8.84 grants the MTS Committee new authority to establish (i) restrictions applicable to all DPMs regarding the concentration of securities allocable to a single DPM and to affiliated DPMs, and (ii) minimum eligibility standards applicable to all DPMs which must be satisfied for a DPM to receive allocations of securities, including but not limited to, standards relating to adequacy of capital and number of personnel. If a DPM is not performing to the required level with the securities it has already been allocated, the MTS Committee may limit the DPM's eligibility to receive additional securities.

F. Proposed Rule 8.85—DPM Obligations

Proposed Rule 8.85 establishes that each DPM, with respect to each of its allocated securities, must fulfill all of the obligations under Exchange Rule applicable to market makers, floor brokers, and order book officials. The proposed rule also sets forth the specific obligations of DPMs that are currently contained in CBOE Rule 8.80, some of which have been modified to clarify their scope.

For example, proposed Rule 8.85(a)(ix) restates the current requirement that the DPM is responsible for determining any formula used for generating automatically updated market quotes and for disclosing the elements of the formula (unless exempted as proprietary by the MTS Committee) to the trading crowd. Proposed Rule 8.85(a)(ix) provides the specific elements of the formula that must be disclosed, such as the option pricing calculation model, volatility, interest rate, dividend, and what is used to represent the price of the underlying security.

Proposed Rule 8.85(b)(i) restates the current requirement that a DPM is obligated to place in the public order book any order in the DPM's possession that is eligible for entry, subject to two exceptions. First, proposed Rule

8.85(b)(i)(A) clarifies that a DPM is not obligated to place a book-eligible order in the book if the DPM immediately executes the order upon receipt. Second, proposed Rule 8.85(b)(ii)(B) provides that a DPM may refrain from placing a book-eligible order in the public order book if the customer who placed the order so requests, so long as the DPM announces the information concerning the order that would have been displayed had the order been placed in the public order book in public open outcry.

Proposed Rule 8.85(b)(ii) states that a DPM may not remove any order from the public order book except in two circumstances. First, proposed Rule 8.85(b)(ii) clarifies that a DPM may remove orders, which have been cancelled, executed, or have expired from the public order book. Second, proposed Rule 8.85(b)(ii) clarifies that a DPM may return an order to the number that placed the order upon such member's request.

In proposed Rule 8.85(b)(iii), the Exchange restates its current requirement that a DPM must accord priority to any order that the DPM represents as agent over the DPM's principal transactions. Proposed Rule 8.85(b)(iv) restates the current DPM prohibition that a DPM may not charge any brokerage commission for any order execution for which the DPM acted as both principal and agent. There is, however, an exception to this prohibition set forth in proposed Rule 8.85(b)(iv), if the customer consents.

Finally, proposed Rule 8.85(c)(vi) is a new provision that requires that each DPM segregate, in a manner prescribed by the MTS Committee, its DPM businesses and activities from its other non-DPM businesses and activities.

G. Proposed Rule 8.86—DPM Financial Requirements

Proposed Rule 8.86 sets forth the financial requirements for DPMs.

H. Proposed Rule 8.87—Participation Entitlement of DPMs

The Exchange proposes to formalize the authority of the MTS Committee to determine the participation entitlement for DPMs in proposed Rule 8.87.¹⁴

I. Proposed Rule 8.88—Review of DPM Operations and Performance

Proposed Rule 8.88(a) restates the current rule provision that the MTS Committee or a subcommittee thereof may conduct a review of a DPM's

a substantially similar proposed rule change, which was then presented to the CBOE members for a vote. The CBOE members approved the current proposed rule change on December 14, 1998.

¹³ The Exchange's process for allocating securities to DPMs and market-maker trading crowds is set forth in CBOE Rule 8.95.

¹⁴ Any changes to the formula established by the MTS Committee shall be submitted to the Commission, pursuant to SEC Rule 19b-4. See Amendment No. 6.

operations and performance at any time. In addition, proposed Rule 8.88(a) clarifies that a DPM and its associated persons are obligated to submit information requested by the MTS Committee relating to such a review. The proposed rule requires that each DPM be reviewed on an annual basis rather than a quarterly basis as is currently required. As part of the review, the MTS Committee will consider, among other things, whether a DPM has satisfied its obligations under proposed Rule 8.85.¹⁵

Proposed Rule 8.88(b) expands the market performance evaluation responsibilities of the MTS Committee by requiring it to perform market performance evaluations and remedial action functions for market makers and floor brokers that regularly trade at DPM stations. Proposed Rule 8.88(c) provides that members of the MTS Committee may perform the functions of a floor official at DPM trading stations.

J. Proposed Rule 8.89—Transfer of DPM Appointments

Under current CBOE Rule 8.80(b)(3), a DPM appointment may not be transferred without the approval of the MTS Committee. Proposed Rule 8.89 expands upon this provision by setting forth a detailed procedure to be followed by a DPM in the event it proposes to sell, transfer, or assign any of its interest. The proposed rule change also includes standards to be applied by the MTS Committee to determine whether or not to approve the transfer request.

K. Proposed Rule 8.90—Termination, Conditioning, or Limiting Approval To Act as a DPM

Proposed Rule 8.90 governs the MTS Committee's authority to terminate, condition, and limit the approval of a DPM. The proposed rule restates, with certain clarifications, provisions that are currently contained in CBOE Rule 8.80.

L. Proposed Rule 8.91—Limitations on Dealings of DPMs and Affiliated Persons of DPMs and Guidelines for Exemptive Relief Under Rule 8.91(e) for Members Affiliated With DPMs

Proposed Rule 8.91 restates that rule provisions that are currently found in CBOE Rule 8.81, which restricts the dealings of DPMs and persons associated with DPMs.

The proposed Guidelines for Exemptive Relief set forth the steps that a member affiliated with a DPM must undertake to seek an exemption from the prohibitions found in proposed Rule 8.91 (a) through (c). The Guidelines provide specific requirements and procedures that affiliated members must establish to prevent, among other things, the use of material non-public corporate or market information that may be in the possession of the affiliated member from influencing the conduct of the DPM or to avoid the use of DPM market information to influence the affiliated member's conduct. The Exchange has proposed to allow DPMs and their affiliated members to structure their corporate organizations in such a manner as to create a functional separation, unlike the current rule, which requires that the DPM and its affiliate be actual separate and distinct organizations.¹⁶

M. Deletions from Current DPM Rules

The CBOE also proposes to delete several provisions of the current DPM rules.

IV. Summary of Comments and CBOE Response

The Commission received two comment letters on the proposed rule change.¹⁷ The Exchange submitted written responses to the issues raised in each comment letter.¹⁸ The issues raised by the commenters and the Exchange's response are summarized below.

First, Mr. Gelbort requested that the Exchange clarify the relationship between CBOE Regulatory Circular RG97-114, and the proposed rule change. In RG97-114, the commenter stated that the Exchange "arguably expanded the scope of DPM responsibilities and obligations beyond those specifically enumerated in CBOE rules."

The Exchange responded that it strongly disagreed with Mr. Gelbort's assertion that RG97-114 exceeded the provisions of the Exchange's rules. The Exchange stated that the regulatory circular merely restated various responsibilities and obligations of DPMs that were specifically set forth in the Exchange's rules. Furthermore, the Exchange stated that the regulatory circular merely provided an explanation regarding how these provisions apply to specific situations.

The Exchange stated that it intends to issue a new regulatory circular upon the effectiveness of this proposed rule change that will replace RG97-114. The new circular will contain updated rule references and will describe the updated rule provisions. The Exchange further stated that since RG97-114 will be superseded, there should be no confusion about the relationship between it and the new proposed rules.

Second, Mr. Gelbort stated that proposed Rule 8.85(a)(ix), which provides that the DPM has the obligation to determine the formula for generating automatically updated market quotes and to disclose the formula to members at the trading station, mandates continued DPM control over the sole system for setting quotes in a crowd and restricts the ability of most other market makers to adequately make independent markets.

The Exchange responded that the obligation set forth in proposed Rule 8.85(a)(ix) is a restatement of current Rule 8.80(c)(3). The Exchange stated that the proposal clarifies the components of the formula generated by the DPM for automatically updating market quotes that must be disclosed to the trading crowd. In addition, the proposal provides the MTS Committee with the discretion to allow a DPM to keep proprietary information about the formula confidential.

In response to Mr. Gelbort's statement that DPMs should not have control over these formulas, the Exchange responds that this would be antithetical to the nature and purpose of the DPM system. The Exchange states that the DPM system is a unitary specialist-type trading system and one of its primary objectives is to provide for the centralization of trading functions. The Exchange believes it is imperative that the DPM have control over the disseminated market quotations to be able to fulfill its DPM obligations. An integral part of controlling the DPM's disseminated quotes, CBOE argues, is the ability of the DPM to determine how automatically updated market quotes are generated.

Responding to Mr. Gelbort's assertion that this proposal would restrict the ability of other market makers to make an independent market, the Exchange stated that market makers will continue to have the ability to improve an automatically updated market quote through open outcry. The Exchange explained that CBOE quote reporters are assigned to each trading crowd to input market quotations verbalized by members of the crowd. Moreover, a DPM has the obligation to assure that disseminated market quotes are

¹⁵ See Amendment No. 6, *supra* note 9. As set forth in Amendment No. 6, the MTS Committee will consider whether the DPM has acted in ways that are reasonably designed to make the Exchange competitive with other markets that trade the same securities by considering the Exchange's market share in those multiple-traded options.

¹⁶ See Amendment No. 6, *supra* note 9.

¹⁷ See *supra* note 10.

¹⁸ See letters from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly Riley, Attorney, Division, SEC, dated July 7, 1999 and February 17, 2000.

accurate, which includes assuring any market maker quote that improves the market is properly disseminated.

Third, Mr. Gelbort suggested that the last sentence of 8.85(a)(ix) could be read to relieve non-DPM market makers of certain market maker obligations while in the presence of a DPM. This sentence states that, in the event of inconsistency between specific DPM obligations in proposed Rule 8.85 and the general market maker obligations found under the market maker rules, the specific obligations applying to the DPM shall govern. The Exchange responded that it did not agree with the commenter's interpretation and stated that proposed Rule 8.85(a)(ix) does not, and will not be interpreted to, relieve market makers of any obligations under the Exchange's rules.

Finally, Mr. Gelbort suggested, in reference to proposed Rule 8.88(c), that MTS Committee members acting as floor officials or otherwise should be specifically precluded from intervening in any dispute that involves an affiliated member or co-employee.

The Exchange responded that current Exchange procedures already preclude such conflicts. The CBOE submitted Regulatory Circular RG96-81, which sets forth committee standards and procedures and specifically provides that a committee member should recuse himself from participation in any committee action if he believes that he may not be able to participate in a fair and impartial manner. In particular, if the committee member has a business relationship with an individual or entity that is the subject of a committee discussion or vote, member recusal would be appropriate. The Exchange believes that this regulatory circular specifically addresses the concerns raised by Mr. Gelbort.

In his comment letter, Mr. Rushlie raised two concerns with the proposed rule change. First, Mr. Rushlie asserted that he believed that the "new" DPM system would limit competition within each pit because non-DPM traders would be forced to "go along with the DPM's markets" or risk being cut out of trades. Second, Mr. Rushlie questioned the validity of the member vote taken to approve the proposed rule change. Specifically, he asserted that seat holders not present on the floor of the Exchange were not given the opportunity to vote on the proposal.

In response to Mr. Rushlie's comments, the Exchange first clarified that the DPM system is not new to the CBOE floor and that the proposal only seeks to reorganize and restructure the current rules applicable to DPMs. The Exchange strongly disagreed with Mr.

Rushlie's first concern about market makers being forced to go along with DPMs or risk being cut out of trades. The Exchange stated that any action on the floor that would act to discourage a member from making competitive markets would be a serious rule violation. Further, the Exchange noted that Mr. Rushlie failed to identify any proposed rule that would restrict the ability of a market maker from competing with a DPM to improve DPM markets.

In response to Mr. Rushlie's comment that the vote was invalid because seat owners were not provided with the right to vote on the proposal, the Exchange cited CBOE Rule 8.95.03. This rule states that a trading crowd may decide that it no longer wishes to trade an options class that opened for trading prior to May 1, 1987. Pursuant to this rule, market makers and floor brokers that satisfy specified transaction requirements may vote. The rule, however, does not require that a member own a membership to be eligible to vote. Thus, according to the Exchange, the vote was held in a manner consistent with its rules.

Finally, the Exchange stated that Exchange members were given ample notice and opportunity to vote on the proposal before its submissions to the Commission and that members voted to approve the proposal.

V. Discussion

After careful review, 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.¹⁹ In particular, the Commission believes that the proposal is consistent with the requirements of Sections 6(b)(3)²⁰ and 6(b)(5)²¹ of the Act. Section 6(b)(3) requires, among other things, that the rules of an exchange assure a fair representation of its members in the administration of its affairs.²² Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in

general, protect investors and the public interest.²³ Moreover, Section 6(b)(5) requires that the rules of a national securities exchange be designed to not permit unfair discrimination between customers, issuers, brokers, or dealers.²⁴

The CBOE's DPM program has been utilized for approximately 13 years. During this time, the program has successfully grown to include 58 DPMs that are allocated over 1400 options classes. The Commission is not aware of any substantial problems arising from the workings of the program and believes that the proposed rules approved today will help clarify and govern the DPM program.

As stated above, the Commission believes that the proposed rule change is consistent with Section 6(b)(3) of the Act.²⁵ Specifically, proposed Rule 8.82 provides members with the ability to nominate members of the MTS Committee, which is the committee that implements and monitors the DPM program. Further, members will now be able to vote for the candidates for this committee. Currently, the CBOE Board of Directors appoints members of the MTS Committee that are nominated by the CBOE Nominating Committee. By providing members with the opportunity to choose their representation on the MTS Committee, members will now have a voice and be actively involved in the policies and oversight of the DPM system.

The Commission finds that the proposed rules approved today promote just and equitable principles of trade consistent with Section 6(b)(5) of the Act²⁶ because they provide a cohesive set of rules governing the DPM trading program. For example, proposed Rule 8.85 sets forth an extensive list of obligations to be fulfilled by each DPM. Under this proposed rule, the DPM is required to fulfill all of the obligations under Exchange rules that are applicable to market makers, floor brokers, and order book officials. Proposed Rule 8.85 also sets forth specific DPM obligations, such as the manner in which the DPM must segregate its transactions and the manner in which it must disseminate automatically updated market quotes. These DPM obligations should ensure that the DPM maintains a fair and orderly market in its allocated securities.

The proposed rule also mandates how a DPM must handle customer limit orders and the priority that must be

¹⁹ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁰ 15 U.S.C. 78f(b)(3).

²¹ 15 U.S.C. 78f(b)(5).

²² 15 U.S.C. 78f(b)(3).

²³ 15 U.S.C. 78f(b)(5).

²⁴ *Id.*

²⁵ 15 U.S.C. 78f(b)(3).

²⁶ 15 U.S.C. 78f(b)(5).

afforded to customer orders. Proposed Rule 8.85(b)(i) states that a DPM is required to place in the public order book any order in its possession that is book eligible (subject to two exceptions), while proposed Rule 8.85(b)(ii) requires that a DPM may not remove any order from the public order book, except in two specific circumstances.

One of the exceptions to proposed Rule 8.85(b)(i) states that a DPM is not required to place a book-eligible order in the public order book if the DPM executes the order immediately upon receipt. This exception should ensure investors that have marketable orders receive more timely executions by clarifying that the DPM is not required to first place the order in the public order book if it intends to immediately execute the book-eligible order. The second exception to proposed Rule 8.85(b)(i) allows a DPM to not place a book-eligible order in the public order book if the customer so requests. Upon receipt of such order, however, the DPM must announce the order in public outcry. This requirement should accommodate investors who desire a price improvement opportunity before execution, while also requiring that the order be disclosed to members of the trading crowd so that they are not at an informational disadvantage. These proposed changes should ensure that DPMs handle orders in a fair manner, which should, in turn, help to ensure liquidity and best execution of customer orders.

The Commission also finds that the proposed rules provide protection to investors and the public interest consistent with the requirements of Section 6(b)(5).²⁷ For example, the definition of the term, DPM, has been amended to allow only member organizations to become DPMs. This modification should ensure that each DPM has a formal organizational structure to govern the manner in which it operates, which should provide investors with a more stable and professional DPM program. In addition, this requirement should enhance the qualifications and abilities of DPMs on the Exchange floor.

The proposed rule change also deletes a provision that allowed DPM nominees, upon departure from the DPM, to request that the DPM's allocated securities be open to reallocation. By eliminating this requirement, the DPM program should have more continuity. Today, according to the Exchange, many DPMs are much larger and nominee turnover is more

frequent. Therefore, the departure of nominees does not have the impact it once had and the current rule is no longer justified.

Investors' interests also are protected by the clarified role of the MTS Committee. For example, under proposed Rule 8.81, the MTS Committee will now have the authority to limit the activities or require the supervision of DPM Designees. This requirement should provide an additional layer of supervision over inexperienced DPM Designees, which should ensure that customer orders are handled properly.

Moreover, the MTS Committee, pursuant to proposed Rule 8.83, must take into consideration many factors in determining whether to allow a member organization to act as a DPM. Such factors include the organization's adequacy of capital, operational capacity, trading experience, regulatory history, and market performance. These factors should ensure that those organizations approved to act as DPMs have the ability to perform successfully and competently. In addition, the MTS Committee will be required to review DPMs on an annual basis pursuant to proposed Rule 8.88. The MTS Committee will review each DPM's operations and performance to determine if the DPM is adequately performing its duties. Although the proposed rule change reduces the number of reviews from quarterly to annually, the annual review conducted by the MTS Committee should be more extensive. Moreover the MTS Committee will continue monitor DPMs throughout the year and address any problems or issues as they may arise.

Proposed Rule 8.86 and the accompanying proposed regulatory circular increase the financial requirements of DPMs. The Commission finds that the increased requirements should enhance investor protections by ensuring that DPMs have sufficient capital to maintain an orderly market for its allocated securities.

Further, the proposal to delegate specific oversight authority to other appropriate Exchange committees should enhance the fair and consistent application of the CBOE's rules and policies for all members. While all Exchange members have been held to the same standards, those standards will now be interpreted and applied by a single committee in a more consistent fashion.

The Commission finds that the transfer rules set forth in proposed Rule 8.89 generally protect the public interest because it provides a detailed procedure that must be followed in the event of a

sale, transfer, or assignment of any ownership interest or any change in its capital structure. Because the Exchange has an interest in approving transfers to ensure that its members are qualified and able to execute their obligations, the Commission finds that the proposed rule to be consistent with the Act.

Finally, proposed Rule 8.91 should ensure that DPMs are not involved in inappropriate conflicts of interest, which could potentially harm investors and the integrity of the Exchange. The proposed guidelines for exemptive relief allow DPMs to be affiliated with other persons or entities so long as procedures are established to restrict any improper flow of material, non-public information. The CBOE has proposed to require that a DPM and its affiliates be functionally separate entities, rather than specifically separate organizations, as currently required. The functional separation must include appropriate procedures to restrict the flow of material, non-public information. Thus, a DPM must establish an information barrier between its DPM activities and its affiliate's business activities.

The Commission believes that this proposed structure is consistent with Section 6(b)(5) of the Act²⁸ because it is designed to prevent fraudulent and manipulative acts and practices, and to protect investors and the public interest. The CBOE guidelines have been drafted to prevent inappropriate use of non-public information by DPMs and their affiliates that could result in market manipulation. The Commission expects the CBOE to continue to monitor DPMs and their affiliates to ensure that their corporate structures and information barriers continue to satisfy these goals.

The Commission also finds that the proposed rule change is consistent with the requirements of the Act because it clearly sets forth the obligations of DPMs. The Exchange has added new rules, which should provide DPMs with adequate notice of the obligations and duties expected by the Exchange and the procedures and ramifications for failing to adequately comply with such obligations and duties.

The Exchange also proposed to delete paragraph (c)(iii) of proposed Rule 8.85 and added language addressing the same issue to proposed Rule 8.88. This proposed amendment deletes the affirmative obligation that a DPM be required to increase the Exchange's order flow in securities allocated to the DPM. The Commission believes that it is more appropriate to measure a DPM's performance in its allocated securities by considering, among other things, the

²⁷ 15 U.S.C. 78f(b)(5).

²⁸ 15 U.S.C. 78f(b)(5).

Exchange's market share in a DPM's allocated securities rather than generically requiring a DPM to act in such a manner to increase the Exchange's market share.

Finally, the commission is satisfied that the Exchange adequately addressed the issues raised in the comment letters. Upon approval of this order, the Exchange represents that it will issue a regulatory circular to inform its members of the changes to the DPM rules. This regulatory circular will replace the current RG97-114 and should minimize member confusion.

The Commission finds good cause to accelerate approval of Amendment Nos. 2 through 6 to the proposed rule change prior to the thirtieth day after the date of publication in the **Federal Register**. In Amendment No. 2, the Exchange only made non-substantive, grammatical changes to the proposed rule change and did not change the meaning or intent of the proposed rule change. Moreover, the changes submitted in Amendment No. 2 did not raise any issue of regulatory concern regarding the proposed rule change. Therefore, the Commission believes that good cause exists, consistent with Section 6(b)(5)²⁹ and Section 19(b)³⁰ of the Act, to approve the amendment on an accelerated basis.

In Amendment No. 3, the Exchange made conforming changes to proposed Rule 8.82 to make it consistent with the proposed changes to the Exchange's constitution.³¹ The Commission notes that these changes were approved by the Exchange's membership and have been noticed in the **Federal Register** for public comment. The Commission did not receive any comment on these changes. Thus, the Commission is satisfied that the Exchange's membership and the public received adequate notice and had a reasonable opportunity to comment on these changes and therefore, these changes may be approved without further publication.

In Amendment No. 4, the Exchange reinstated the current provision that prohibits a DPM from initiating a transaction for its own account that would result in a stop or stop limit order, which the DPM represents as agent, from being put into effect except with the approval of a floor official. The Commission believes that this provision provides significant protections for investors and, thus, it is appropriate to accelerate approval.

In Amendment No. 4, the Exchange also deleted a provision of proposed Rule 8.85(b) that would have permitted a DPM, with MTS Committee approval, to represent discretionary orders under unusual circumstances. Given the potential for conflicts of interest in representing such orders, the Commission believes that it is appropriate to accelerate approval of the proposed deletion of this provision.

Finally, in Amendment No. 4, the Exchange clarified the use of DPMs on an interim basis. The Amendment expressly provides that DPMs appointed on an interim basis must satisfy all of the DMP obligations. The Commission believes that this should help protect investors by ensuring that DMPs appointed on an interim basis satisfy all of the organizational and financial requirements that are required of permanent DPMs.

In Amendment No. 5, the Exchange confirmed that any changes to the DMP financial guidelines proposed by the MTS Committee must be submitted to the Commission, pursuant to SEC Rule 19b-4. The Commission is required to review the financial requirements imposed on DPMs as part of its regulatory responsibilities. Thus, Amendment No. 5 did not contain any new issue of regulatory concern.

In Amendment No. 6, the Exchange proposed to add language to proposed Rule 8.85(a)(viii) to make it consistent with the current language of CBOE Rule 8.80(c)(7). Since this change does not change the intent or meaning of the proposed rule change and only made non-substantive changes, the Commission believes that good cause exists to accelerate its approval.

The Exchange also proposed to delete paragraph (c)(iii) of proposed Rule 8.85 and add language addressing the same issue to proposed Rule 8.88. The Commission notes that the Exchange proposed this change in response to concerns raised by Commission staff.

In addition, the Exchange proposed to delete the discretion it proposed to be granted to itself under the Guidelines for Exemptive Relief Under proposed Rule 8.91(e). Instead, the CBOE proposes to allow DMPs and their affiliates to be structured so as to create a functional separation. The Commission notes that the CBOE has based this proposal on language found in the rules of the Pacific Stock Exchange and the International Securities Exchange.³² The Commission believes that the proposed amended language adequately addresses the potential misuse of material, non-public

information between DPMs and their affiliates. Further, the Commission believes that deleting proposed provision granting the non-specific discretion of the Exchange should ensure that the guidelines are applied evenly and consistently.

Finally, in Amendment No. 6, the Exchange clarified that any changes to the formula for determining the participation entitlement, pursuant to proposed Rule 8.87, must be submitted to the Commission, pursuant to Rule 19b-4. Therefore, the Amendment only clarified the Commission's regulatory authority and did not change the meaning or intent of the proposed rule change. Therefore, for the reasons discussed above, the Commission believes that good cause, consistent with Section 6(b)(5)³³ and 19(b)³⁴ of the Act, to accelerate approval of Amendment Nos. 2, 3, 4, 5, and 6.

Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 2 through 6, including whether they are 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 at the Commission's Public Reference Room. Copies of such filings also will be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File SR-CBOE-98-54 and should be submitted by August 2, 2000.

VII. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act³⁵ that the amended proposed rule change (SR-CBOE-98-54) is approved, and Amendment Nos. 2, 3, 4, 5, and 6 are approved on an accelerated basis.

²⁹ 15 U.S.C. 78(f)(5).

³⁰ 15 U.S.C. 78s(b).

³¹ See *supra* note 6.

³² See PCX Rule 4.20 and ISE Rule 810.

³³ 15 U.S.C. 78f(b)(5).

³⁴ 15 U.S.C. 78s(b).

³⁵ 15 U.S.C. 78s(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁶

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43010; File No. SR-CHX-00-08]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Chicago Stock Exchange, Inc., To Establish a Board Review Process for Decisions of the Exchange's Committee on Specialist Assignment and Evaluation Regarding Specialist Firm Consolidations

July 5, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 17, 2000, the Chicago Stock Exchange, Inc. ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On April 3, 2000, the Exchange amended the proposal.³ 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

The Exchange proposes to amend CHX Article XXX, Rule 1, Interpretation .01 to establish a board review process for certain decisions of the Exchange's Committee on Specialist Assignment and Evaluation ("Committee"). The text of the proposed rule change is below. Proposed additions are in italics. Proposed deletions are in brackets.

ARTICLE XXX

Specialists

Registration and Appointment

RULE 1. No change to text.

* * * Interpretations and Policies

.01 Committee on Specialist Assignment & Evaluation

ASSIGNMENT FUNCTION

I. Events Leading to Assignment Proceedings

Pursuant to Article XXX, Rules 1 and 8, the Committee may, when circumstances require, assign or reassign a security. *Eight* [Seven] circumstances may lead to the need for assignment of a security. They are:

1. New listing or obtaining unlisted trading privilege;
2. Specialist request;
3. Corporation request;
4. Split-up and/or merger of specialist units;
5. Fundamental change of specialist unit;
6. *Consolidations creating Concentration*;
- [6.]7. Unsatisfactory performance action; or
- [7.]8. Disciplinary action.

The following guidelines have been adopted by the Exchange [Committee] for [its] use in the assignment or reassignment of stocks among co-specialists. These guidelines set forth the general policy [of the Committee] concerning the posting and allocation of stocks. They are not, however, rigid rules to be strictly followed regardless of unique circumstances. These guidelines form only the starting point of [the Committee's] deliberations; they will be applied in light of the facts in each individual case. *An assignment may be made subject to such conditions as are appropriate. If any such condition is not met, the stock shall be immediately posted for reassignment.*

- 1.-5. No change to text.
6. *Consolidations creating Concentration.*
 - (a) *Whenever a specialist unit acquires, merges, creates a joint trading account or other profit-sharing arrangement with one or more other specialist units or otherwise comes under common control with one or more other specialist units (a "Consolidation") the assignments of the affected stocks shall be subject to Committee review and approval.*
 - (b) *When a Consolidation creates or increases a specialist unit's financial interest in trades constituting 10% or more of the total Exchange trade volume in the three preceding calendar months ("Concentration"), the Committee will consider:*
 - (i) *the effect of the consolidation on the specialist units'*
 - A. *Capital supporting specialist activities;*
 - B. *Experience and quality of management;*
 - C. *Experience and performance of co-specialists;*
 - D. *Risk controls and procedures;*
 - E. *Operational efficiencies; and*
 - (ii) *the effect of the consolidation on the Exchange's ability to:*
 - A. *Enhance its competitive position;*
 - B. *Minimize risk to the financial integrity of the marketplace; and*
 - C. *Continue operating in the public interest.*

[6]7. No change to text.

[7]8. No change to text.

II. Assignment Procedures

* * * * *

4. *Board Review. The full Board of Governors, excluding those Governors that*

are co-specialists or affiliates of co-specialists (a "Board Panel"), may on its own initiative review any decision of the Committee involving a change in control or consolidation of a specialist unit. The Board Panel shall give any interested member an opportunity to present its views on the matter. A Committee decision will be final if any member of a Board Panel, within ten days of a Committee decision, does not request that the Board Panel initiate a review. Notwithstanding the foregoing, a Board Panel will review all decisions made with respect to Consolidations creating Concentration. The decision of the Board Panel is final.

[4]5. No change to text.

* * * * *

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

In its filing with the Commission, the Exchange 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.

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

1. Purpose

The Exchange proposes to amend its rules to establish a board review process for certain Committee decisions. Specifically, the Exchange proposes an amendment to CHX Article XXX, Rule 1, Interpretation .01.

The Committee currently is charged with approving the assignment of stocks to specialist firms and their co-specialists, as well as evaluating the performance of such specialists and co-specialists. The Committee also reviews and must approve the transfers of assigned issues that typically occur in connection with the acquisitions of specialist firms by other specialist firms.

The Exchange is experiencing significant consolidation of its specialist firms. The Exchange's Board of Governors ("Board") believes that specialist firm consolidations, and the concentration of business that can result from these consolidations, can raise issues that are significant in the context of the Exchange's long-term business plan and operational forecasts. These issues are beyond those typically addressed by the Committee in the ordinary stock allocation process. The Board thus has determined that it is

³⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See March 31, 2000 letter from Ellen J. Neely, Vice President and General Counsel, CHX, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC ("Amendment No. 1"). In Amendment No. 1, the Exchange made minor, technical changes to the proposal.