

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50996; File No. SR-CBOE-2004-77)

January 7, 2005

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to the Systematizing of Orders in Connection with the Requirement to Design and Implement a Consolidated Options Audit Trail System

I. Introduction

On November 24, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend its rules relating to the systematization of orders in connection with the requirement to design and implement a consolidated options audit trail system ("COATS"). The proposed rule change was published for notice and comment in the Federal Register on December 6, 2004.³ The Commission received 2 comment letters on the proposed rule change.⁴ This order approves the proposed rule change.

II. Background

The proposed rule change is intended to fulfill certain of the undertakings contained in an order issued by the Commission relating to the settlement of an enforcement action against the American Stock Exchange LLC, CBOE, Pacific Exchange, Inc. and Philadelphia Stock Exchange, Inc. (collectively "Options Exchanges") for failure to comply with their own rules and to enforce compliance with their own rules by their members and persons associated with their

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 50755 (November 30, 2004), 69 FR 70482.

⁴ See email from Brian Meister, CBOE Floor Broker, O'Connor and Co., LLC, dated December 26, 2004 and Richard T. Marnaris, CBOE Floor Broker, dated December 21, 2004.

members⁵ as is required by Section 19(g) of the Act.⁶ The Order found that the Options Exchanges impaired the operations of the options market by: (i) following a course of conduct under which they refrained from multiply listing a large number of options; and (ii) inadequately discharging their obligations as self-regulatory organizations by failing adequately to enforce compliance with (a) certain of their rules, including order handling rules, that promote competition as well as investor protection, and (b) certain of the rules prohibiting anticompetitive conduct, such as harassment, intimidation, refusals to deal and retaliation directed at market participants who sought to act competitively. In addition, the Commission found that the Options Exchanges failed to enforce compliance with their trade reporting rules, which promote transparency of the market and facilitate surveillance and enforcement of other exchange rules and the federal securities laws.

As part of the Order, the Options Exchanges agreed to, and were ordered to comply with, a variety of undertakings. Among other things, they agreed to, and were ordered to, design and implement COATS to enable the Options Exchanges to reconstruct markets promptly, effectively surveil them and enforce order handling, firm quote, trading reporting and other rules. The Options Exchanges were required to complete this undertaking in five phases. The Options Exchanges have completed the first four phases. The final phase of the undertaking to implement COATS requires that each exchange incorporate into its audit trail all non-electronic orders. This proposed rule change addresses that aspect of the undertaking.

⁵ See Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Sanctions, Securities Exchange Act Release No. 43268 (September 11, 2000) and Administrative Proceeding File 3-10282 (the “Order”).

⁶ 15 U.S.C. 78s(g).

III. Description of Proposed Rule Change

To assure that all non-electronic orders are incorporated into COATS for Phase V, the CBOE proposes to amend CBOE Rule 6.24, which currently requires orders to be in written form. The proposed rule change generally would require that each order, change to an order, or cancellation of an order transmitted to the Exchange be “systematized,” in a format approved by the Exchange, either before it is sent to the Exchange or contemporaneously upon receipt on the floor of the Exchange, and prior to representation of the order.

CBOE proposes that each order, change to an order, or cancellation of an order may be systematized in one of two ways. First, if an order, change to an order, or cancellation of an order is sent electronically to the Exchange, would be considered to be systematized. Second, if an order, change to an order, or cancellation of an order that is sent to the Exchange non-electronically is input electronically into the Exchange’s systems contemporaneously upon receipt on the Exchange and prior to representation, it would be considered to be systematized. The requirement would proposed to commence on January 10, 2005. With respect to non-electronic orders received in the S&P 100 index option class (OEX), the S&P 500 index option class (SPX), and the European-style S&P 100 index option class (XEO), however, CBOE proposes that the requirement to systematize orders prior to representation would commence on March 28, 2005.

Although the proposed rule change generally requires that each order be systematized prior to representation, the Exchange proposes to treat market and marketable orders differently than other orders so that marketable orders may be represented immediately in the marketplace. Specifically, with respect to non-electronic market and marketable orders sent to the Exchange, CBOE proposes to provide that the member responsible for systematizing the order must input into the Exchange’s systems the following specific information with respect to a market or

marketable order prior to the representation of the order: (i) the option symbol; (ii) the expiration month; (iii) the expiration year; (iv) the strike price; (v) buy or sell; (vi) call or put; (vii) the number of contracts; and (viii) the Clearing Member. Any additional information with respect to the order would be inputted into the Exchange's systems contemporaneously thereafter, which may occur after the representation and execution of the order.

CBOE also proposes to amend Interpretation .04 to CBOE Rule 6.73, to make explicit that a broker's responsibility to immediately and continuously represent market and marketable orders would be subject to the requirement that each order must be systematized prior to representation.

In proposed new subparagraph (a)(4) of CBOE Rule 6.24, the Exchange proposes that in the event of a malfunction or disruption of the Exchange's systems such that a member is unable to systematize an order, the member or member organization would be required to use paper trade tickets to record order information during the time period that the malfunction or disruption occurs. Upon the cessation of the malfunction or disruption, the member would be required to immediately resume systematizing orders. In addition, the member would be required to exert best efforts to input electronically into the Exchange's systems all relevant order information received during the time period when there was a malfunction or disruption of the Exchange's systems as soon as possible, and in any event would be required to input such data electronically into the Exchange's systems not later than the close of business on the day that the malfunction or disruption ceases.

The Exchange proposes to keep the current Interpretation and Policy .02(a) of CBOE Rule 6.24, which permits the use of hand signal communications on the floor to, among other things, initiate an order, cancel an order or to change material terms of an order. However, the

Exchange proposes to clarify that any initiation, cancellation, or change of an order relayed to a floor broker through the use of hand signals also must be systematized upon receipt in accordance with paragraph (a) of CBOE Rule 6.24. The proposed rule change also deletes paragraph (b) of Interpretation .02 as paragraph (a) of that interpretation is being amended to delete the reference to exempt classes.

The Exchange proposes to add a new Interpretation and Policy .04 to CBOE Rule 6.24, which states that accommodation liquidations as defined in CBOE Rule 6.54 are exempted from the systematization requirement. However, the Exchange commits to maintain quotation, order and transaction information for accommodation liquidations in the same format as the COATS data is maintained, and will make such information available to the SEC upon request.

The Exchange also proposes to add a new Interpretation and Policy .05 to CBOE Rule 6.24, which states that FLEX options, as described in Chapter 24A of the Exchange's rules, are exempt from the requirements of the Rule. However, the Exchange commits to maintain as part of its audit trail quotation, order and transaction information for FLEX options in a form and manner that is substantially similar to the form and manner as the COATS data is maintained, and will make such information available to the SEC upon request.

The Exchange proposes to include a new Interpretation .06 to CBOE Rule 6.24, which provides that any proprietary system approved by the Exchange on the Exchange's trading floor that receives orders would be considered an Exchange system for purposes of paragraph (a)(1) of this Rule. This proposed rule would require that any proprietary system approved by the Exchange must comply with the requirements of COATS.

Finally, the Exchange has proposed a new Interpretation .07 to CBOE Rule 6.24, which would require that each order transmitted by a Market-Maker while on the floor, including any

cancellation of or change to such order, must be systematized in accordance with the procedures described in Paragraph (a) and (b) of this Rule, as applicable. Currently, paragraph (d) of CBOE Rule 6.24 requires that each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, must be recorded legibly in a written form that has been approved by the Exchange, and must be time stamped immediately prior to its transmission. The new proposed interpretation thus would require that each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, be systematized in accordance with CBOE Rule 6.24.

IV. Summary of Comments

The Commission received comment letters from 2 CBOE floor brokers opposing the systematization prior to representation of an order requirement.⁷ Both commenters were concerned that this requirement might harm customers by delaying the execution and possibly causing the customer orders to lose the market.

V. Discussion

After careful consideration, the Commission finds that the proposed rule change is consistent with Act and the rules and regulations thereunder applicable to a national securities exchange. In particular the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁸ which requires among other things, that the Exchange's rules be designed to promote just and equitable principles of trade, to remove impediments and to perfect

⁷ See *supra* Note 4.

⁸ 15 U.S.C. 78f(b)(5).

the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest.⁹

The Commission believes that the rules as proposed should allow the Exchange to comply with its obligations under the Order in that they will result in the creation of an audit trail that incorporates manual orders sent to CBOE. Specifically, the proposed rules will require that each order, change to an order, or cancellation of an order must be systematized prior to representation.

With respect to market and marketable orders, the Exchange proposes to require that floor brokers must enter only eight order data elements into the Exchange's systems prior to representation. These elements are: (i) the option symbol; (ii) the expiration month; (iii) the expiration year; (iv) the strike price; (v) buy or sell; (vi) call or put; (vii) the number of contracts; and (viii) the Clearing Member. The Exchange represents that limiting the number of elements that must be entered prior to representation will permit marketable orders to be represented immediately in the marketplace as customers expect and as members representing those orders are obligated to do. The Commission notes that two commenters expressed concern that the requirement to systematize certain information prior to representation would harm investors.¹⁰ The Commission notes, however, that only a limited amount of information about an order would be required to be systematized prior to representation under the proposal. Moreover, the Commission believes that the order elements proposed to be captured for market and marketable orders should be sufficient to distinguish one order from another order that a member may receive at or about the same time to ensure an accurate audit trail. Therefore, the Commission

⁹ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹⁰ See supra note 4.

believes that it is appropriate and consistent with the goals of investor protection to permit the capture of only the above-referenced order data elements prior to representation for market and marketable orders.

The Commission also believes that the Exchange's plan for recording order details in the event of a systems outage or malfunction is reasonable. In the event of a systems outage or malfunction, floor brokers would revert to the use of trade tickets and would record on those tickets the times that various events occur in the life of the order. Further, the Exchange would ensure that the information recorded on trade tickets is entered into the Exchange's electronic systems in a timely manner so that it can be incorporated into the electronic audit trail.

The Commission notes that the Exchange has acknowledged the need for effective and proactive surveillance for activities such as trading ahead and front-running in connection with the creation of its audit trail. The Exchange represents that it currently conducts automated surveillance for such activities and will incorporate a review of order systemization as part of such surveillance. The Exchange also states that it intends to implement supplementary surveillance and examination programs related to the systemization of orders requirement promptly after this requirement is instituted, which are designed to address, among other things, trading ahead and front-running. The Commission views effective surveillance as critical to the integrity of COATS and expects that the Exchange will inform the Commission of any problems it encounters in conducting effective surveillance.

VI. Conclusion

For all of the aforementioned reasons, 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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹¹ that the proposed rule change (SR-CBOE-2004-77) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland
Deputy Secretary

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).