

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40283; File No. SR-CBOE-98-27]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. and Amendments Nos. 1, 2 and 3 Relating to Enhancements to the Exchange's Order Execution System

July 30, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on June 16, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" 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 CBOE. On June 23, 1998, the CBOE submitted to the Commission Amendment No. 1 to the proposed rule change.² On July 15, 1998, the CBOE submitted to the Commission Amendment No. 2 to the proposed rule change.³ On July 21, 1998, the CBOE submitted to the Commission Amendment No. 3 to the proposed rule change.⁴ 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 CBOE is amending its rule governing the execution of orders by an Order Book Official ("OBO") or the Designated Primary Market-Maker ("DPM") book staff to provide for the electronic execution of certain orders on

the "live ammo" screen. This change is being accommodated by an enhancement to the Exchange's order execution systems.

The text of the proposed rule change is available at the Office of the Secretary, CBOE and at the Commission.

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 CBOE 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 CBOE 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

The CBOE is amending one of its rules to allow an OBO or a DPM to designate orders to be electronically executed against market-makers standing in the crowd. Currently, an OBO or a DPM, acting in his or her capacity as an OBO, represents in the trading crowd the orders that have been placed on the customer limit order book. These orders are represented individually when they become marketable and are traded with the market-makers standing in the crowd. The OBO (or DPM) is able to determine which orders are marketable by reviewing his or her "live ammo" screen, which is an electronic book screen that displays orders that are market orders or limit orders that improve the market.⁵ However, when the live ammo screen experiences a large influx of orders it becomes

difficult for the OBO (or DPM) to represent and execute these orders individually in a timely manner and a sizable backlog can develop. This is particularly true during opening rotations when a large number of orders can build up on the "live ammo" screen.

To speed the process of the OBO or DPM executing live ammo orders, the CBOE is proposing to change its order execution systems to allow the OBO or DPM to select orders to be executed electronically. The OBO or DPM may select for electronic execution one order individually or he or she may, after reviewing the orders on the screen, select all orders displayed on a live ammo page (currently a page may contain up to thirteen orders).⁶ Orders selected for electronic execution against a participating market-maker must meet the same criteria as those for Retail Automatic Execution System ("RAES") eligible orders. To be eligible to be executed on RAES, the order must be a marketable limit order that is for the number of contracts established by the Equity Floor Procedure Committee for that options class (or fewer), pursuant to Rule 6.8(e).⁷ Orders that are not RAES eligible when the page is selected will remain on the live ammo screen. Any market-maker who is signed onto RAES at the time the OBO or DPM selects the order or orders for electronic execution will be eligible to be electronically assigned as the contra-party on the trade.

In Amendment No. 1, the CBOE altered the proposed rule's language, adding conditions for when the OBO or DPM may route a live ammo order for electronic execution.⁸ The OBO or DPM may do so when he or she believes there are unusual market conditions or when there is a large influx of orders to the live ammo screen. Moreover, the OBO or DPM must consult with the crowd before routing a live ammo order or orders for electronic execution.

In Amendment No. 2, the CBOE added language to the proposed rule change, explaining that the rule would operate notwithstanding the priority provisions of paragraphs (a) and (b) of CBOE Rule 6.45.⁹ CBOE Rule 6.45 gives priority to some bids and offers, because they were made earlier in time, over other bids and offers. The Exchange

¹ 15 U.S.C. 78s(b)(1).

² In Amendment No. 1, the Exchange changed the proposed rule language, clarifying when the new provision may be exercised. The Exchange also further explained how the altered system operates. See Letter from Timothy H. Thompson, Director, Regulatory Affairs, Legal Department, CBOE, to Richard Strasser, Assistant Director, Division of Market Regulation ("Division"), Commission, dated June 23, 1998 ("Amendment No. 1").

³ In Amendment No. 2, the Exchange further detailed the operation of its computer system and altered the proposed rule language to clarify the new rule's interaction with CBOE Rule 6.45. See Letter from Timothy H. Thompson, Director, Regulatory Affairs, Legal Department, CBOE, to Richard Strasser, Assistant Director, Division, Commission, dated July 10, 1998 ("Amendment No. 2").

⁴ In Amendment No. 3, the Exchange further explains the new rule's interaction with CBOE Rule 6.45. See Letter from Timothy H. Thompson, Director, Regulatory Affairs, Legal Department, CBOE, to Richard Strasser, Assistant Director, Division, Commission, dated July 20, 1998 ("Amendment No. 3").

⁵ There are generally six ways an order may be routed to the live ammo screen. First, if a customer submits a cancel/replace order to the market for an order already held by the book that order will go to the live ammo screen. Second, if a customer submits a cancel/replace order to a limit price that betters the same-side market quote for an order held by the book, that order will go to the live ammo screen. Third, market orders received through the Exchange's order shoe and that are manually booked will go to the live ammo screen. Fourth, limit orders that better the same-side market quote, that are received through the order shoe, and that are manually booked will go to the live ammo screen. Fifth, limit orders that better the same-side market quote and that are routed directly to the Electronic Book when the routing parameters have been set at "0" will go to the live ammo screen. Sixth, marketable limit orders that are electronically booked from a floor broker's PAR workstation will go to the live ammo screen. See Amendment No. 2.

⁶ Amendment No. 1 clarified that, in addition to accepting one order or a whole page or orders, the system also can accept any number of orders from the same page at one time. See Amendment No. 1.

⁷ Most option classes have an eligible order size for RAES of ten contracts. Some have an eligible order size of twenty contracts.

⁸ See Amendment No. 1.

⁹ See Amendment No. 2.

explains that it is possible that a RAES-eligible live ammo order may be executed prior to a non-RAES eligible order received earlier.¹⁰ The Exchange believes these occurrences will be infrequent for two reasons. First, the non-RAES-eligible order must be for the same series as the RAES-eligible order that is traded for there to be an interruption of the normal priority principles. Second, for the RAES-eligible order to trade ahead of the non-RAES-eligible order, the limit price of the non-RAES-eligible order must be at the CBOE's quoted market because that is the price at which the RAES-eligible order will be executed. When the limit for the larger non-RAES-eligible order is at the market, the CBOE book staff will act to execute that order promptly. Therefore, it is only in those cases where the CBOE book staff has not had the opportunity to fill those executable non-RAES-eligible live ammo orders before sending orders for electronic execution that the RAES-eligible order will be filled before the non-RAES-eligible order that has time priority. Based on its experience with how book staffs generally handle their orders, the Exchange believes that, once the system is in place, the book staff will usually attempt to fill the larger orders that were first in time before they send live ammo orders to be electronically executed. Alternatively, one member of the book staff may seek to execute the larger non-RAES eligible orders at the same time another member sends the RAES-eligible live ammo orders to be electronically executed.

Regardless of the possibility that RAES-eligible live ammo orders may trade ahead of non-RAES-eligible orders, the Exchange believes that the current proposal is in the best interest of the CBOE marketplace and public customers. This is because the system will only be employed when the OBO or DPM believes there to be unusual market conditions or when there is a large influx of orders to the live ammo screen. In these situations the employment of this system will allow the book staff and the crowd to attend to the execution of other business and will improve the turnaround time of many customer orders. Any non-RAES-eligible live ammo orders that were not executed before the live ammo orders

were sent to be electronically executed could be executed at this time assuming they are marketable.

The Exchange also notes that the system will retain book priority. This means, for example, if the book staff selects a page of live ammo orders to be electronically executed at the time the CBOE's best bid or offer on the limit order book equals the prevailing market quote, no live ammo orders will be executed but those orders will remain on the live ammo screen. Only after those booked orders have been executed (or the market changes) will the book staff be able to effectively send the live ammo orders to be electronically executed.¹¹

In general, the proposed system change will significantly improve the turnaround time of customer orders and will allow book staff and market-makers in the crowd to attend to the transaction of other orders during busy times. The Exchange also believes this system change will alleviate the need to declare fast markets in certain situations because it will allow for the faster execution of orders and will prevent orders in the live ammo screen from becoming backlogged.

Because the system enhancements to the Exchange's order execution systems will allow for the OBO or DPM to avoid a backlog of orders on the live ammo screen and thus to allow market-makers and the book staff to attend to other business, the Exchange believes this rule change is consistent with and furthers the objectives of Section 6(b)(5) of the Act in that it would foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities, and would remove impediments to and perfect the mechanism of a free and open market in a manner consistent with the protection of investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The CBOE does not believe that the proposed rule change will impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. 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-98-27 and should be submitted by August 27, 1998.

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

Margaret H. McFarland,
Deputy Secretary.

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¹⁰ In Amendment No. 3, the Exchange clarified that the time priority provisions of CBOE Rule 6.45 will continue to govern the sequence in which RAES-eligible orders are executed using the new electronic execution feature. See Amendment No. 3.

¹¹ See Amendment No. 2.

¹² 17 CFR 200.30-3(a)(12).