

of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>12</sup>

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to File No. SR-Amex-2002-29 and should be submitted by May 13, 2002.

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

**Margaret H. McFarland,**

*Deputy Secretary.*

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45757; File No. SR-CBOE-99-45]

#### Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Partial Approval of Proposed Rule Change and Amendment No. 2 Thereto To Clarify Certain Aspects of Interpretation and Policy .02 to CBOE Rule 6.8

April 15, 2002.

On August 19, 1999, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to clarify certain aspects of Interpretation and Policy .02 to CBOE Rule 6.8. On December 28, 1999, the proposed rule change was published for comment in the **Federal Register**.<sup>3</sup> On November 19, 2001, the Exchange amended the proposal to establish criteria to describe the circumstances in which Exchange Floor Officials may determine that quotes from one or more markets in one or more particular classes of options are not reliable, and, thus, may be excluded from CBOE's Retail Automatic Execution System ("RAES") determination of the National Best Bid and Offer ("NBBO").<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on January 8, 2002.<sup>5</sup> The Commission received one comment letter on the amended proposal from the International Securities Exchange LLC ("ISE").<sup>6</sup> The Commission is granting approval to that portion of the proposal that: (i) Allows two Floor Official to determine that quotes in one or more particular options classes in a market are not reliable and thus may be excluded from the NBBO under the

following two circumstances: (a) where a market confirms that its quotes are not firm based upon direct communication to CBOE from the market or the dissemination through OPRA of a message indicating that disseminated quotes are not firm; or (b) where a market directly communicates to CBOE or otherwise confirms that it is experiencing systems or other problems affecting the reliability of its disseminated quotes; (ii) sets forth the procedures to be followed once a determination of unreliability has been made; (iii) sets forth when such determination will expire; (iv) sets forth the documentation and reporting requirements as a result of such determination; and (v) relabels a portion of the current Interpretation .02(a) text as .02(b) and relabels the current Interpretation .02(b) text as .02(c) (together, the "Confirmed Unreliable Quote and Related Procedures Portion").

#### I. Description of Proposal

The CBOE proposed that two Floor Officials could determine that quotes in one or more particular option classes in a market were not reliable and thus could be excluded from the NBBO determination under any of the following circumstances: (a) Receipt of direct communication from the market or dissemination through OPRA of a message indicating that the exchange's disseminated quotes are not firm; (b) direct communication or confirmation from another market that it is experiencing systems or other problems affecting the reliability of its disseminated quotes; (c) one or more Floor Officials observe that six or more option series in a particular options class are crossed or locked with the disseminated quotes of two or more other markets, and continue to be crossed or locked for 30 seconds or more (and are crossed or locked at the time Floor Officials determine to exclude the quote from the determination of the NBBO); or (d) a Floor Official observes any of the following: (1) One or more orders originating from an exchange's designated market maker or market maker for a particular options class that are filled by the market at a worse price than its disseminated quote without a required quote change; (2) one or more market orders or marketable limit orders originating from an exchange's designated market maker or market maker for a particular options class that are confirmed to be unfilled or partially unfilled by the market without a required quote change; or (3) one or more market orders or marketable limit

considered the proposed rules impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>12</sup> For purposes of calculating the 60 day abrogation period, the Commission considers the period to commence on April 8, 2002, the date that the Exchange filed Amendment No. 1.

<sup>13</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.

<sup>3</sup> See Securities Exchange Act Release No. 42256 (December 20, 1999), 64 FR 72707 (December 28, 1999).

<sup>4</sup> See letter from Joanne Moffit-Silver, General Counsel and Corporate Secretary, Legal Department, CBOE to Stephen M. Cutler, Director, Division of Enforcement, Commission, Annette L. Nazareth, Director, Division of Market Regulation, Commission, and Lori A. Richards, Director, Office of Compliance, Inspections and Examination, Commission, dated November 19, 2001 ("Amendment No. 2").

<sup>5</sup> See Securities Exchange Act Release No. 45221 (January 2, 2002), 67 FR 947.

<sup>6</sup> See letter from Michael J. Simon, Senior Vice President and Secretary, ISE, to Mr. Jonathan G. Katz, Secretary, Commission, dated January 23, 2002.

orders originating from an exchange's designated market maker or market maker for a particular options class partially filled by a responsible broker or dealer at a worse price than its disseminated quote, followed by a quote change and a redisplay of the previously disseminated quote by the same responsible broker or dealer in less than 30 seconds.

CBOE proposed that in all instances where Floor Officials exclude a market or any of its quotes from the determination of the NBBO due to quote unreliability, the Exchange Control Room would promptly notify the market of the action and continue to actively monitor the reliability of the excluded quotes in consultation with Floor Officials. Any determination to exclude a market or any of its quotes pursuant to (a) or (b) would expire at the end of the trading day, or at such time as the quotes were confirmed by the market to be reliable again "whichever occurs first. Any determination to exclude a market or any of its quotes pursuant to (c) and (d) would expire not later than 30 minutes after the initial determination, unless two Floor Officials determine that the excluded quotes continue to be unreliable, in which case the quotes would continue to be excluded for an additional period of time, not to exceed 30 minutes pending further Floor Official review.

Pursuant to CBOE's proposal, exclusion of a market or its quotes from the determination of the NBBO would be reported to Exchange member firms.

In addition, CBOE stated that pursuant to CBOE Rule 8.51(e), CBOE is required to document in its Control Room log any action taken to disengage RAES or to operate RAES in a manner other than normal, the option classes affected by such action, the time such action was taken, the Exchange officials who undertook such action, and the reasons why such action was taken. Therefore, any determination by Floor Officials to exclude unreliable quotes from the NBBO would be documented in the Exchange's Control Room log.

CBOE's proposal also relabeled a portion of the current Interpretation .02(a) text as .02(b) and relabeled the current Interpretation .02(b) text as .02(c).

## II. Summary of ISE Comment Letter and CBOE Response

### A. ISE Comment Letter

In its comment letter, ISE stated that it believed CBOE's proposal was motivated by CBOE's frustration with its inability to "clear" the superior quotes on other markets due to the bifurcated

application of the Commission's Quote Rule 7 on the options exchanges: a responsible broker or dealer has to be firm for its disseminated quotation up to its stated size only for customers and may be firm for non-customers at the disseminated quotation for only one contract. As a result, a designated primary market maker ("DPM") on the CBOE floor cannot access a superior quote on another exchange's floor for more than one contract, and therefore, cannot "clear" that superior quote to execute a customer order at the inferior price disseminated by the CBOE.

However, ISE also stated that excluding quotations from an exchange's NBBO is appropriate in the first three instances proposed by the CBOE: When an exchange designates a quotation as "non-firm" through OPRA; when an exchange specifically confirms to the CBOE that it is experiencing systems or other problems; and when there are widespread locked or crossed markets. ISE stated that in those limited circumstances there is clear, objective evidence that an exchange's disseminated quotation is suspect and that a customer may not receive an execution at that quotation if the customer's order were routed directly to that exchange. ISE also stated that excluding quotations from the NBBO in these three situations would be consistent with the intermarket options linkage plan approved by the Commission in July 2000 ("Linkage Plan").<sup>7</sup> The Linkage Plan exempts an exchange member from liability for trading through the quote of another market if the quote is non-firm or if there is a systems or equipment failure. The Linkage Plan also provides procedures requiring an exchange to unlock or uncross a market, which the ISE believes indicates that the dissemination of a locked or crossed market will be fleeting and likely will not be accessible for any length of time.

However, the ISE also expressed its concern that CBOE might abuse the application of these provisions. Specifically, ISE was concerned with CBOE removing the entire ISE market from its NBBO, instead of only removing unreliable quotes, due to CBOE's technical limitations. In addition, ISE stated that the remainder of CBOE's proposal raised serious legal and policy questions. ISE believes that although the proposed exclusions from the NBBO based on documented firm quote issues would not affect the ISE,

they are contrary to the requirements of the Act and are inconsistent with the Linkage Plan. If a member of any exchange fails to honor its quotation, or does not properly fade its quotation under the rules of the member's exchange, ISE believes that a customer of another exchange should not suffer an inferior execution. Rather, that member is violating the rules of the exchange and is subject to disciplinary action. ISE expects that the CBOE staff would call such action to the attention of the offending exchange, and that exchange would take prompt regulatory action. In addition, ISE pointed out that the Linkage Plan does not except from liability a CBOE member that trades-through a quotation on another exchange due to previous instances of an exchange member failing to honor or fade its quotation.

The ISE also explained its anonymous, auction-based, electronic competitive market maker system, in which if an ISE market maker does not execute an order to the full size of the market maker's quotation available to customers, the ISE system automatically fades the remainder of the market maker's quotation. Absent a change in the price of the underlying security, the market maker is prohibited from reinstating that quotation for 30 seconds. However, ISE explained that its quote could stay the same for three permitted reasons: (i) A market maker other than the market maker that executed the original trade could quote at the price of the previous execution; (ii) an Electronic Access Member could enter a limit order on the book at the price of the previous execution; or (iii) the price of the underlying security could change and the market maker that executed the original trade could change its quotation to its previous price. ISE noted that whether a new ISE quote at the price of a previous execution is a permitted quote change or the result of an ISE market maker inappropriately requoteing at that price cannot be accurately ascertained outside of ISE's market. Therefore, ISE is concerned that CBOE floor officials will wrongfully assume that ISE members are reentering quotations within 30 seconds, and will inappropriately exclude ISE quotations from the CBOE NBBO, which will deny customers the opportunity to achieve the best execution of their orders.

Finally, ISE stated that the intermarket linkage will permit CBOE market makers to access superior quotations of other markets, which will eliminate any need for CBOE's proposal. ISE further stated that the delay in implementation of the linkage should not be used to justify CBOE's proposal

<sup>7</sup> Rule 11Ac1-1 under the Act, 17 CFR 240.11Ac1-1.

<sup>8</sup> See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000).

since the delay is due to CBOE and the interim linkage currently operating provides CBOE with much the same protection as CBOE's proposal.

#### B. CBOE's Response

On February 28, 2002, CBOE submitted a letter responding to ISE's comment letter.<sup>9</sup> In its letter, CBOE disagreed with ISE's assertions that CBOE's proposal was motivated by CBOE's inability to "clear" superior quotations on other exchanges. CBOE explained that its proposal was designed to eliminate unreliable quotes that result in an inaccurate NBBO because an unreliable NBBO distorts marketplace pricing and can lead to missed executions. CBOE noted that it has refined its systems and no longer removes all ISE quotations for an occurrence of non-firm quotes occurring in just one options class.

With respect to ISE's argument that CBOE's proposal conflicts with the Linkage Plan, CBOE noted that the Linkage Plan is not operational yet and will not be in place until next year. Until the permanent linkage is implemented, CBOE believes it would be unreasonable to apply strictly the provisions of the Linkage Plan to the operation of the options market because without the permanent linkage, it is very difficult for a market maker to test the reliability of a quote in an away market in a quick and efficient manner. Once the permanent linkage is operational, CBOE agrees that the fourth group of exclusions in its proposal need not be broader than the allowable trade-through circumstance in the Linkage Plan. CBOE also stated that the interim linkage is insufficient to address unreliable quotes because such arrangements do not allow DPMs to submit proprietary orders to the auto-execution systems of the linked exchange and thus, do not enable DPMs to efficiently probe the reliability of the quote in the away market. In addition, the interim linkage only covers a small minority of options.

With respect to ISE's objections to the portion of CBOE's proposal relating to firm quote circumstances, CBOE argues that the proposal is designed to prevent a customer from receiving an inferior execution because the alleged "superior" quote is not obtainable. With respect to ISE's objection to the part of CBOE's proposal relating to the redisplay of a quote within 30 seconds, CBOE believes ISE wants to be held to

a different standard from the other options exchanges merely because it is electronic. CBOE notes that although ISE market makers each enter their own quotes, the ISE publishes a collective quote. CBOE states that ISE's collective quote should be held accountable for adherence to trade or fade because individual market makers on ISE do not have to interact with a DPM order. CBOE believes that if the entire DPM order were exposed to all market makers on ISE it might receive a complete fill, thus obviating the need to fade a quote, or not, in which case the quote should be faded.

#### III. Discussion

The Commission finds that the Confirmed Unreliable and Related Procedures Portion of the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>10</sup> and, in particular, the requirements of section 6 of the Act<sup>11</sup> and the rules and regulations thereunder. The Commission finds that the proposed rule change is consistent with section 6(b)(5) of the Act<sup>12</sup> because it provides objective criteria and well-defined procedures for excluding an unreliable quote from CBOE's determination of the NBBO, which should increase the likelihood that only unreliable quotes will be excluded from the CBOE's determination of the NBBO. Specifically, the Commission notes that the floor officials' determination to exclude unreliable quotes contained in the Confirmed Unreliable Quote and Related Procedures Portion of the proposal is limited to circumstances in which the away market has either directly communicated or confirmed that its quotes are unreliable. In this way, the discretion afforded to CBOE floor officials to determine that another market's options quotes are unreliable is appropriately limited. Moreover, the recordkeeping requirements and other procedures proposed in the Confirmed Unreliable Quote and Related Procedures Portion of the proposal are not unreasonable.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>13</sup> that the portion of the amended proposed rule change set forth above as the Confirmed Unreliable Quote and Related Procedures Portion of the proposal (SR-

CBOE-99-45) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,<sup>14</sup>

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

[FR Doc. 02-9779 Filed 4-19-02; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45755; File No. SR-CHX-2002-10]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Stock Exchange, Incorporated to Extend a Pilot Rule Interpretation Relating to Trading of Nasdaq/NM Securities in Subpenny Increments

April 15, 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 April 10, 2002, the Chicago Stock Exchange, Incorporated ("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 Exchange filed the proposal pursuant to Section 19(b)(3)(A) of the Act,<sup>3</sup> and Rule 19b-4(f)(6)<sup>4</sup> thereunder, which renders the proposal effective upon filing with the Commission. 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 proposes to extend through September 30, 2002, the pilot rule interpretation relating to the trading of Nasdaq/NM securities in subpenny increments. The pilot is due to expire on April 15, 2002. The CHX does not propose to make any substantive or typographical changes to the pilot; the only change is an extension of the pilot's expiration date through September 30, 2002. The text of the proposal is available at the Commission and at the CHX.

<sup>9</sup> See letter from Joanne Moffic-Silver, General Counsel and Corporate Secretary, Legal Department, CBOE, to Jonathan G. Katz, Secretary, Commission, dated February 25, 2002.

<sup>10</sup> In approving this proposed rule change, the Commission notes that it has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f.

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78s(b)(2).

<sup>14</sup> 17 CFR 200.30-2(a)(12).

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6). The Commission waived the 5-day pre-filing notice requirement.