For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[18]

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42168; File No. SR–CBOE–99–61]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to Non-Automatic Handling of RAES Orders

November 22, 1999.

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 November 8, 1999, 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 and II below, which Items have been prepared by the Exchange. On November 22, 1999, CBOE submitted Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice and order to solicit comments on the proposed rule change from interested persons and to approve the proposal on an accelerated basis for a ninety day pilot to expire on February 21, 2000.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CBOE proposes to amend its rule governing the operation of its Retail Automatic Execution System (''RAES'') to allow, under certain circumstances, orders to be rejected from RAES and routed to the Public Automated Routing terminal (''PAR'') for manual handling. 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 III 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

1. Purpose

The purpose of the proposal is to allow, under certain circumstances, orders to be rejected from RAES for manual handling where the bid or offer for a series of options generated by the Exchange's Autoquote system becomes crossed or locked with the best offer or bid for that series as established by a booked order. The proposed rule is intended to correct an unintended consequence of the planned implementation of the Automated Book Priority (''ABP'') system that could have significant detrimental effects on the operation of the RAES as described further below. The CBOE anticipates that the number of orders that will be rejected from RAES under this proposed rule should represent only a small subset of the orders that have been and currently are rejected pending implementation of the ABP system.

The Exchange's ABP system will allow an order entered into RAES to trade directly with an order on the Exchange's customer limit order book where the prevailing market bid or offer is equal to the best bid or offer on the Exchange's book.[4] The Commission recently approved the Exchange's rules implementing the ABP system,[5] which has not yet been implemented.[6]

The Exchange recently became aware of an unintended consequence of the operation of the ABP system. That is, in situations where the best bid or offer for one or more series of a particular option class is established by one or more orders in the book, the market-makers logged on to RAES for that class of options could be subject to a substantial risk in the event that the market in the underlying stock moves significantly and quickly in a direction that makes the booked order price substantially better than the price calculated by CBOE's Autoquote formula. In that event, while the booked order would quickly be executed, CBOE represents that the ABP system may not be able to react quickly enough to remove the executed order from the limit order book. As a result, once ABP is implemented, orders entered in RAES would automatically be executed against the stale bid or offer still being shown in the book notwithstanding the booked order having already been executed. CBOE contends that this result could cause direct and substantial economic disadvantage to the market-makers who are obligated to participate in RAES executions. The Exchange believes that implementing ABP without addressing this potential risk could cause market-makers to avoid participating on RAES (thus, affecting the liquidity of lower volume series traded on RAES and endangering the viability of RAES), or to widen their quotes to minimize the possible adverse consequences of executing orders based on stale quotes and to account for the potential losses (thus, affecting the ability of CBOE's market-makers to compete with competing specialists or market-makers). In the alternative, market-makers might request that the Equity Floor Procedure Committee reduce the size of orders eligible for RAES to minimize the impact of these orders (thus, eliminating a significant advance in automatic execution that CBOE represents its customers have requested).

[18] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] In Amendment No. 1, CBOE shortened the length of the pilot program from one year to ninety days. *See* letter from Timothy Thompson, Director, Regulatory Affairs, CBOE, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission, dated November 19, 1999.

[4] In the event the order in the book is for a smaller number of contracts than the RAES order, the balance of the RAES order will be assigned to participating market-makers at the same price at which the rest of the order was executed.

[5] *See* Securities Exchange Act Release No. 41995 (October 8, 1999), 64 FR 56547 (October 20, 1999) (File No. SR–CBOE–99–29).

[6] Currently, with certain exceptions discussed below, when a RAES order is entered into the Exchange's Order Routing System when the prevailing market bid or offer is equal to the best bid or offer on the Exchange's book, the order will be routed electronically to a Floor Broker's terminal or work station in the crowd subject to the volume parameters of each firm. Today, the orders are routed to the Floor Brokers instead of being automatically executed in the crowd at the market price, because execution with the crowd would be inconsistent with CBOE Rule 6.45, which provides that bids or offers displayed on the customer limit order book are entitled to priority over other bids or offers at the same price. CBOE permits RAES orders in options on IBM, options on the Dow Jones Industrial Average (DJX) and options on the Standard & Poor's 100 Stock Index (OEX) to be executed on RAES even if the prevailing market bid or offer equals the best bid or offer on the Exchange's book. In other words, RAES orders in these options classes are currently allowed to ''trade through'' the book. Upon implementation of the ABP system, RAES orders in these option classes, like all other option classes, will trade against orders in the book in these circumstances.

CBOE explains the potential risk market-makers could be subject to by implementing the ABP system without the proposed ''carve out'' by way of example. Assume that in a volatile internet stock (where the maximum order size for RAES has been established at 50 contracts) small customer orders in the book are establishing the best bid in six different series. In one particular series, Series A, assume that the CBOE market is 5 (bid)—5 1/8 (offer), with a book order to buy 5 contracts at $5 (which establishes the best bid). Assume further that the price of the underlying internet stock drops precipitously in a matter of seconds. When the underlying stock moves, the Exchange's Autoquote system will update CBOE market-makers' quotes for the options overlying that stock. [7] Assume with the drop in the underlying stock, the Exchange's Autoquote system establishes a bid and offer of 4 3/4—4 7/8 for Series A. (The same scenario would play out with the other five series whose best bid is established by an order in the book.) The order in the book representing the best bid will likely be immediately executed by the crowd in the auction market. For some period of time after the trade has been consummated in open outcry, however, the bid will still be displayed as CBOE's bid while the Order Book Official physically punches the keys to take the bid down from the display. During the period, the displayed bid of 5 in the book will be out of line with the theoretical bid 4 3/4 generated by CBOE's Autoquote system. In the meantime, traders who have equipped themselves with the necessary computer equipment and communications facilities could have identified the pricing disparity between the theoretical price of the options and the displayed best bids, could automatically generate orders to sell the affected options and route those orders to RAES. If RAES is allowed to operate as it does under normal circumstances, each order to sell that arrives at the Exchange from these investors, for so long as the out-of-line book bid continues to be displayed, will be assigned to market-makers in the trading crowd who are logged on to RAES. These market-makers in turn will be obligated to buy at the $5 bid, which could be significantly away from the theoretical bid.[8] Of course, the same adverse consequence could be experienced in the other five series of the class in which the bid was established by a booked order.

The Exchange believes that by rejecting orders from RAES in the limited situation where the bids or offers generated by Autoquote become crossed or locked with the CBOE's best bid or offer as established by an order in the Exchange's customer limit order book, the problem described above can be resolved without any significant disruption in the proper handling of customer orders or to the market as a whole. The Exchange will then be able to offer RAES to its customers together with the benefit of the ABP system, which will allow RAES orders to trade directly with orders on the Exchange's customer limit order book. Those orders that are rejected from RAES in the limited circumstances when Autoquote crosses or locks the book will be immediately and automatically routed to a broker's PAR terminal in the trading crowd (absent contrary instructions of the firm), where they will be represented by the broker and, if executable, will ordinarily be executed in seconds. Because these orders remain RAES eligible, they will be entitled to receive firm quote treatment when they are represented in the crowd.

The Exchange represents that during the course of the pilot program, the Exchange will monitor those situations in which RAES orders are rejected as provided in the rule and will prepare a report to the Commission describing its experience with the rule before the end of the pilot program.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with and furthers the objectives of Section 6(b)(5)[9] of the Act in that it is designed to remove impediments to a free and open market and to protect 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. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule 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 CBOE. All submissions should refer to File No. SR–CBOE–99–61 and should be submitted by December 21, 1999.

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful review, the Commission finds that the proposed pilot is consistent with the requirements of the Act.[10] In particular, the Commission finds the proposal is consistent with Section 6(b)(5) [11] of the Act. Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade and to protect investors and the public interest.

The Commission believes that it is imperative that CBOE implement the ABP system as expeditiously as possible to ensure that all customer limit orders on CBOE are, where appropriate, given priority over other interest on the Exchange. After the ABP system is implemented, RAES orders will be able to trade against orders in the book when the prevailing market bid or offer equals the best bid or offer in the Exchange's

[7] In approving this pilot, the Commission takes no position with respect to the procedures involved in CBOE's Autoquote system, which are the subject of pending proposal SR–CBOE–98–04.

[8] If, for example, six different traders use such a system to identify pricing disparities and to generate and send orders instantly for automatic execution, market-makers in the trading crowd could be responsible for trading 295 or 300 contracts of Series A options alone, reflecting an aggregate payment of as much as $150,000 more than their theoretical value. The maximum number of contracts to be purchased in response to six orders for 50 contracts each would be 300 contracts, except in the unlikely event that the original 5 contract order on the book had not yet been filled, in which case 5 contracts of the orders received would trade with the booked order, and market makers would be obligated to buy the remaining 295 contracts.

[9] 15 U.S.C. 78f(b)(5).

[10] In addition, pursuant to Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[11] 15 U.S.C. 78f(b)(5).

limit order book. Implementation of the ABP system should provide for more efficient execution of both RAES and booked orders. The proposed rule change, which would result in RAES orders being routed to the trading crowd when the Exchange's Autoquote system locks or crosses CBOE's best bid or offer as established by the book, limits market-maker risk where CBOE is unable to remove a quote based on a customer limit order that has already been executed. The Exchange has represented that this exception should occur very infrequently.

In light of the likely benefits to customer limit orders expected to be gained by implementation of the ABP system, particularly in those classes, discussed above, where CBOE currently permits RAES orders to trade through orders on the limit order book, the Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. The Commission hereby requests that CBOE provide monthly reports to the Commission regarding the number of times the exception that is the subject of this pilot is used to allow the Commission to determine whether to approve the proposal permanently.[12]

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[13] that the proposed rule change (SR–CBOE–99–61) is hereby approved through February 21, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[14]

Margaret H. McFarland,

Deputy Secretary.

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[12] The approval of the pilot should not be interpreted as suggesting that the Commission is predisposed to approving the proposal permanently.

[13] 15 U.S.C. 78s(b)(2).

[14] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42167; File No. SR–CBOE–99–57]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 by the Chicago Board Options Exchange, Inc. Governing the Operation of Its Retail Automatic Execution System

November 22, 1999.

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 October 14, 1999, 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. Additionally, on November 15, 1999, the Exchange filed with the Commission Amendment No. 1 to the proposal.[3] 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 CBOE proposes to amend its rules governing the operation of its Retail Automatic Execution System (''RAES''). 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.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Timothy Thompson, Director of Regulatory Affairs, CBOE, to Gordon Fuller, Special Counsel, Division of Market Regulation, SEC, dated November 15, 1999. The Amendment clarifies the wording of the proposed rule change. Because of the substantive nature of the amendment, the Commission deems the filing date of the proposed rule change to be November 15, 1999.

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

1. Purpose

The purpose of the proposed rule change is to permit the appropriate Floor Procedure Committee (''FPC'') to designate that RAES orders for a particular option series will default for manual representation in the trading crowd in situations where the National Best Bid or Offer (''NBBO'') for that particular series of that class is crossed (*e.g.,* 6⅛ bid, 6 asked) or locked (*e.g.,* 6 bid, 6 asked). The proposed rule will provide market-makers participating on RAES protection from having to fill orders at crossed or locked prices since the NBBO can become crossed or locked as a result of one market disseminating inaccurate or delayed quotes.

Currently, under CBOE Rule 6.8(a)(ii), when RAES receives an order, the system automatically will attach to the order its execution price, determined by the prevailing market quote at the time of the order's entry into the system, except as otherwise provided in Interpretation .02 of CBOE Rule 6.8 in respect of multiply-traded options. A buy order will pay the offer; a sell order will sell at the bid.

Pursuant to Interpretation .02, when RAES receives an order for a multiply-traded option at a time when a better bid or offer for that option is displayed on another exchange, the order will either be rejected for manual handling (so that the order is not automatically executed at an inferior price to the NBBO) or the order will be executed at the NBBO, if the NBBO is better than the CBOE bid or offer by no more than the designated number of minimum trading variations (''ticks''). The appropriate FPC determines which option classes will be entitled to be executed automatically at the better bid or offer and also determines the number of ticks better than the CBOE bid or offer that the NBBO may be and at which the order still will be executed automatically on RAES.[4] In situations where the NBBO for a particular series is more than the designated number of ticks better than the CBOE bid or offer, the order for that multiply-traded class will be rerouted for manual handling.[5]

[4] *See* Securities Exchange Act Release No. 41821 (September 1, 1999), 64 FR 50313 (September 16, 1999), approving SR–CBOE–99–17. SR–CBOE–99–17 amends Interpretation .02 to authorize the appropriate FPC to establish a step-up amount greater than the one-tick increment established under CBOE Rule 6.42.

[5] Any orders prevented from being automatically executed by operation of this policy will be