

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47200; File No. SR-CBOE-2002-63]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. Proposing To Allow Limited Side-by-Side Trading and Integrated Market Making for Certain Securities and Their Related Options

January 15, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 16, 2002, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed Amendment No. 1 to the proposed rule change on December 27, 2002.<sup>3</sup> The Exchange filed Amendment No. 2 to the proposed rule change on January 2, 2003.<sup>4</sup> 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

CBOE proposes to amend Exchange rules and the related Interpretations and Policies to allow for limited "Side-by-Side Trading"<sup>5</sup> and "Integrated Market

Making"<sup>6</sup> for certain securities and their related options. The text of the proposed rule change follows. Additions are in *italics*. Deleted text is in [brackets].

\* \* \* \* \*

#### Chapter XXX

##### Part A—Trading in Stocks, Warrants, and Other Securities

##### General Floor Prohibitions

Rule 30.18. No member of the Exchange, while on the floor, shall:

(a) Dealing When Option Granted or Held. *Except as otherwise provided in Section (d) below*, [I] initiate the purchase or sale on the Exchange of any security subject to the Rules in this Chapter, for his own account or for any account in which he, his member organization or any person associated with such member or member organization is directly or indirectly interested, including by means of the issuance or acceptance of a commitment or obligation to trade, where (i) such member holds, or has sold or granted, an option or warrant on that security, or (ii) such member has knowledge that his member organization or any person associated with such member or member organization holds, or has sold or granted, any such option or warrant; or

(b) No change.

(c) No change.

(d) *Notwithstanding the foregoing:*

(i) *The DPM or an associated person of the DPM for an IPR, IPS, or TIR that meets the criteria set forth in Interpretation and Policy .03 of this Rule may act as a DPM, market-maker, and/or floor broker in the related options without implementing procedures to restrict the flow of information between them and without any physical separation between the trading in the underlying IPR, IPS, or TIR and the trading in the related options.*

(ii) *Reserved.*

\* \* \* Interpretations and Policies

.01 No change.

.02 No change.

.03 *The criteria to qualify particular IPRs, IPSs and TIRs for side-by-side trading and integrated market making pursuant to Exchange Rule 30.18(d)(i) are as follows:*

a. *Component securities that in the aggregate account for at least 90% of the weight of the portfolio must have a minimum market value of at least \$75 million.*

b. *The component securities representing 90% of the weight of the portfolio each have a minimum monthly trading volume during each of the last six months of at least 250,000 shares.*

c. *The most heavily weighted component security cannot exceed 25% of the weight of the portfolio and the five most heavily weighted component securities cannot exceed 65% of the weight of the portfolio.*

d. *The underlying portfolio must include a minimum of 13 securities.*

e. *All securities in the portfolio must be listed on a national securities exchange or the NASDAQ Stock Market.*

#### Chapter 30

30.18A. *An option DPM that is also approved as a DPM in the underlying security in a side-by-side trading environment pursuant to Exchange Rule 30.18(d)(i) is required to disclose on request to all participants in the option or security trading crowds information about aggregate buying and selling interest at different price points represented by limit orders then being represented or otherwise held by the DPM.*

\* \* \* Interpretations and Policies

.01. *"Side-by-side trading" refers to the trading of options and their underlying securities in the same physical vicinity, though not necessarily by the same DPM or firm.*

.02. *Notwithstanding the fact that a DPM's option transactions may be in conformity with Rule 30.18 and its Interpretations and Policies, such DPM shall nonetheless be deemed to be in violation of Rule 30.18 if the DPM has engaged in such option transactions for manipulative purposes.*

#### 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 III below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

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

<sup>3</sup> On December 27, 2002, the Exchange filed a Form 19b-4, which replaced the original filing in its entirety ("Amendment No. 1"). In Amendment No. 1, the Exchange withdrew the portion of the proposed rule change to permit limited integrated market making of securities admitted to dealings on an UTP basis and their related options if information barriers are established, approved and maintained. In addition, the Exchange amended the proposal to designate the proposed rule change as filed under section 19(b)(3), rather than section 19(b)(2), of the Act.

<sup>4</sup> See letter from Christopher Hill, Attorney, CBOE, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated December 30, 2002 ("Amendment No. 2"). In Amendment No. 2, the Exchange provided reasons for requesting that the Commission waive the 5 day pre-filing requirement and the 30 day delay of the operative date as required under section 19(b)(3) of the Act, and Rule 19b-4(f)(6) thereunder.

<sup>5</sup> The Exchange defines "Side-by-Side Trading" as the trading of options and their underlying stocks in the same vicinity, though not necessarily by the same DPM or firm.

<sup>6</sup> The Exchange defines "Integrated Market Making" as the trading of options and their underlying stocks by the same DPM.

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

1. Purpose

Since at least the 1980s,<sup>7</sup> the Commission has expressed concerns regarding potential information advantages and potential opportunities for manipulation that might occur if specialists and market makers could engage in side-by-side trading and integrated market making.

In October of 1990, the Commission approved CBOE rules governing the trading of stocks, warrants, and other securities at CBOE (which are now set forth in Chapter 30 of the CBOE's Rules).<sup>8</sup> During the process of obtaining this approval, CBOE noted to the Commission that no side-by-side trading of stocks and stock options would occur on the same floor, and agreed to submit a proposed rule change under section 19(b) of the Act<sup>9</sup> to the Commission "prior to any modification to its plan to trade stocks in a separate location from the options trading floor."<sup>10</sup> In addition, Exchange Rule 30.18(a), as proposed by the CBOE and approved by the Commission, was "intended to prevent a member from buying or selling an underlying stock on the CBOE when the member or an affiliate has a position in an option or warrant on that security."<sup>11</sup>

Since that time, the core of the CBOE's business has remained primarily in listed options on equities and stock indexes. In recent years, however, the CBOE, in addition to its existing listed options business, has also come to trade a number of products that derive their value from portfolios of other equity securities. These products include among others, Index Portfolio Receipts ("IPRs")<sup>12</sup> and "Index Portfolio

Shares ("IPSS"),<sup>13</sup> which are sometimes collectively referred to as Exchange-Traded Funds ("ETFs"),<sup>14</sup> as well as Trust Issued Receipts ("TIRs").<sup>15</sup>

More recently, the Commission approved the American Stock Exchange LLC ("Amex") filing SR-Amex-2002-21, which authorized the Amex to permit limited integrated market making in its stocks that trade pursuant to unlisted trading privileges ("UTP") and their related options, as well as both integrated market making and side-by-side trading in certain ETF shares and TIRs and their related options.<sup>16</sup>

CBOE expressed concerns about the Amex proposal for side-by-side trading set forth in SR-Amex-2002-21 and the earlier SR-Amex-2001-75.<sup>17</sup> Furthermore, the CBOE believes the Commission's recent approval of SR-

will pay to the redeeming holder the stock and cash then comprising the Portfolio Deposit; and (d) pay holders a periodic cash payment corresponding to the regular cash dividends or distributions declared and paid with respect to the component securities of the stock index on which the IPRs are based, less certain expenses and other charges as set forth in the Trust prospectus. IPRs are "UIT interests" within the meaning of the Rules of the Exchange.

<sup>13</sup> As set forth in Interpretation .03 to CBOE Rule 1.1, the term "Index Portfolio Shares" or IPSS means securities that (a) are issued by an open-end management investment company based on a portfolio of stocks designed to provide investment results that correspond generally to the price and yield performance of a specified foreign or domestic stock index; (b) are issued by such an open-end management investment company in a specified aggregate minimum number in return for a deposit of specified number of shares of stock and/or a cash amount with a value equal to the next determined net asset value; and (c) when aggregated in the same specified minimum number, may be redeemed at a holder's request by such open-end management investment company which will pay to the redeeming holder stock and/or cash with a value equal to the next determined net asset value.

<sup>14</sup> For ease of reference, this rule filing uses the term Exchange-Traded Fund, or ETF, to describe both IPRs and IPSSs. Currently, the Exchange trades the following ETFs listed on the CBOE pursuant to CBOE Rule 31.5(L)-(M): the Nasdaq 100® Index Tracking Stock ("QQQ"), the Standard & Poor's® Depository Receipts (SPY-SPDRs®), and the S&P 100 iShares<sup>SM</sup> ("OEF"). See email from Christopher Hill, Attorney, CBOE, to Christopher Solgan, Attorney, Division, Commission, dated November 12, 2002.

<sup>15</sup> As set forth in Interpretation and Policy .04 to CBOE Rule 1.1, the term "Trust Issued Receipt" means a security (a) that is issued by a trust ("Trust") which holds specific securities deposited with the Trust; (b) that, when aggregated in some specified minimum number, may be surrendered to the Trust by the beneficial owner to receive the securities; and (c) that pays beneficial owners dividends and other distributions on the deposited securities, if any are declared and paid to the trustee by an issuer of the deposited securities. TIRs are listed on the CBOE pursuant to CBOE Rule 30.57.

<sup>16</sup> See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002) (approving SR-Amex-2002-21).

<sup>17</sup> See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan Katz, Secretary, Commission, dated July 11, 2002.

AMEX-2002-21, including both the ability to undertake limited side-by-side trading as well as limited integrated market-making, gives substantial competitive advantages to the Amex. Thus, in the interests of promoting a fair and competitive marketplace, the CBOE proposes to undertake integrated market making and side-by-side trading of ETFs and their related options to the same extent that the Commission has approved for the Amex.

Specifically, CBOE proposes to permit side-by-side trading and integrated market making of certain ETFs and TIRs and their related options, if the ETF or TIR meets the criteria set forth in Interpretation and Policy .03 to CBOE Rule 30.18.<sup>18</sup> Specifically, CBOE proposes to permit DPMs and market makers in options on ETF shares and TIRs that meet the criteria set forth in the proposed new Interpretation and Policy .04 to CBOE Rule 30.18 to also act as the DPM and market makers, respectively, in the underlying securities without information barriers or physical barriers. CBOE also proposes new CBOE Rule 30.18A to require a DPM in options on an ETF or TIR that is also the DPM in the underlying security in a side-by-side environment to disclose on request to participants in the ETF, TIR, and option trading crowds information about aggregate buying and selling interest at different price points represented by limit orders on the ETF, TIR or option held by the DPM.

The CBOE notes that it remains concerned about the potential impact of any further expansion of side-by-side trading. While the Commission's approval of SR-Amex-2002-21 compels the CBOE to make this proposed rule change for competitive reasons, CBOE represents that this proposal seeks no more side-by-side trading than what the Commission has approved for the Amex in SR-Amex-2002-21.

<sup>18</sup> The criteria for ETFs and TIRs set forth in the proposed Interpretation and Policy .03 to Rule 30.18 to qualify particular ETFs and TIRs for side-by-side trading and integrated market making are as follows:

(a) Component securities that in the aggregate account for at least 90% of the weight of the portfolio must have a minimum market value of at least \$75 million.

(b) The component securities representing 90% of the weight of the portfolio each have a minimum monthly trading volume during each of the last six months of at least 250,000 shares.

(c) The most heavily weighted component security cannot exceed 25% of the weight of the portfolio and the five most heavily weighted component securities cannot exceed 65% of the weight of the portfolio.

(d) The underlying portfolio must include a minimum of 13 securities.

All securities in the portfolio must be listed on a national securities exchange or the NASDAQ Stock Market.

<sup>7</sup> See Securities Exchange Act Release No. 26147 (October 3, 1988), 53 FR 39556).

<sup>8</sup> See Securities Exchange Act Release No. 28556 (October 19, 1990), 55 FR 43233 (October 26, 1990) (approving SR-CBOE-90-08).

<sup>9</sup> 15 U.S.C. 78s.

<sup>10</sup> See *id.* at 16 and nn. 30-31 (citing letter from Robert Ackerman, Vice President, CBOE, to Howard Kramer, Assistant Director, Division, Commission, dated October 15, 1990).

<sup>11</sup> See Securities Exchange Act Release No. 30068 (December 12, 1991), 56 FR 65764 (December 18, 1991) (approving File No. SR-CBOE-91-45).

<sup>12</sup> As set forth in Interpretation .02 to CBOE Rule 1.1, the term index portfolio receipts or "IPRs" means securities that (a) represent an interest in a unit investment trust ("Trust") which holds the securities that comprise an index on which a series of IPRs is based; (b) are issued by the Trust in a specified aggregate minimum number in return for a "Portfolio Deposit" consisting of specified numbers of shares of stock plus a cash amount; (c) when aggregated in the same specified minimum number, may be redeemed from the Trust which

## 2. Statutory Basis

CBOE believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>19</sup> in general and furthers the objectives of Section 6(b)(5)<sup>20</sup> in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, to protect investors and the public interest and is not designed to permit unfair discrimination between customer, issuers, brokers, or dealers.

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

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

The foregoing rule change, as amended, has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>21</sup> and subparagraph (f)(6) of Rule 19b-4<sup>22</sup> thereunder because it does not: (i) Significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate; and the Exchange has given the Commission written notice of its intention to file the proposed rule change at least five business days prior to filing. At any time within 60 days of the filing of such 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>23</sup>

Under Rule 19b-4(f)(6)(iii) of the Act,<sup>24</sup> the proposal does not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest and the Exchange is required to give the Commission written notice of its intention to file the proposed rule change at least five business days prior to filing. The Exchange has requested that the Commission waive the 30-day operative date and the five-day pre-filing notice requirement in order for it to implement the proposed rule change as quickly as possible. The CBOE contends that this proposed rule is substantially similar to comparable rules the Commission approved for the Amex, which was published for public notice and comment.<sup>25</sup> As a result, the Exchange believes that the proposed rule change does not raise any new regulatory issues, significantly affect the protection of investors or the public interest, or impose any significant burden on competition. The Commission, consistent with the protection of investors and the public interest, has determined to waive the 30-day operative period as well as the five-day pre-filing notice requirement,<sup>26</sup> and, therefore, the proposal is effective and operative upon filing with the Commission.

## 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

day period to have commenced on January 2, 2003, the date CBOE filed Amendment No. 2.

<sup>24</sup> 17 CFR 240.19b-4(f)(6)(iii).

<sup>25</sup> See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002) (approving SR-Amex-2002-21).

<sup>26</sup> For purposes only of waiving the five-day pre-filing notice requirement and the 30-day operative period for this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CBOE-2002-63 and should be submitted by February 18, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>27</sup>

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

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47212; File No. SR-ISE-2002-27]

### **Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change by the International Securities Exchange, Inc., Relating to the Repeal of Limitations on Orders**

January 17, 2003.

On November 21, 2002, the International Securities Exchange, Inc. ("ISE" 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 relating to the repeal of limitations on orders. Notice of the proposed rule change was published for comment in the **Federal Register** on December 16, 2002.<sup>3</sup> No comments were received on the proposed rule change.

The Exchange proposes to repeal the provision in its Rule 717 that prohibits Electronic Access Members ("EAMs") from sending in more than one order every 15 seconds for the same beneficial owner in options on the same underlying security. The ISE adopted this "speed bump" in 2000 to protect ISE market makers from exposure across multiple series of options if they receive orders in many series at the same time.<sup>4</sup> The Exchange now represents that the rule has been outmoded by the development of sophisticated risk management tools and that eliminating this restriction will provide EAMs and

<sup>27</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. 46959 (December 6, 2002), 67 FR 77115.

<sup>4</sup> See Securities Exchange Act Release No. 44017 (February 28, 2001), 66 FR 13820 (March 7, 2001).

<sup>19</sup> 15 U.S.C. 78f(b).

<sup>20</sup> 15 U.S.C. 78f(b)(5).

<sup>21</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>22</sup> 17 CFR 240.19b-4(f)(6).

<sup>23</sup> For purposes of calculating the 60-day abrogation date, the Commission considers the 60-