

Mexican markets are closed on the Friday before expiration and the CBOE is open for trading, the last trading day for expiring IPC Index options on the CBOE will be Thursday.

The Exchange notes that if the Bolsa decides to use a weighted average method to determine the settlement value of IPC options, the CBOE will issue a press release stating that such a determination has been made and listing which series will be affected by the new settlement methodology. The Exchange will also issue a regulatory circular to its members and member firms informing them of the specifics of the settlement methodology, as well as which series will be affected by the new settlement methodology.<sup>5</sup> In addition to distributing the regulatory bulletin on the floor of the Exchange, the Exchange will publish the regulatory circular in its regulatory bulletin.

According to the Exchange, the weighted average methodology is less likely to be manipulated because the settlement value is not determined by reference to only one transaction in each of the component securities, but rather is determined by the weighted average of a series of transactions in each of the component stocks over a period of time at the end of the trading day. Presently, the Bolsa has not made a final determination regarding which settlement methodology it will employ.

## 2. Statutory Basis

The CBOE believes that the proposal is consistent with Section 6(b) of the Act, in general, and furthers the objectives of Section 6(b)(5), in particular, in that it will allow the Exchange to trade IPC options without interruption if the Bolsa changes its settlement methodology. In this regard, the CBOE believes that the rule change furthers the objectives of Section 6(b)(5) of the Act in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, 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 inappropriate burden on competition.

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

Comments were neither solicited nor 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule changes 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 at the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filings also will be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-96-32 and should be submitted by [insert date 21 days from date of publication].

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

The Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, the requirement of Section 6(b)(5) thereunder. Specifically, the Commission finds that the CBOE's proposal to change the method for determining the settlement value of IPC options does not present any new or novel regulatory issues as the Commission has previously approved settlement methodologies utilizing average weighted prices.<sup>6</sup> In addition, by issuing both a press release and a regulatory circular concerning the change in settlement methodology for IPC options, which will include information pertaining to which series will be affected by the new settlement

methodology, investor confusion should be avoided. Lastly, the Commission believes that the weighted average settlement methodology may reduce the susceptibility of the Index to manipulation by diminishing the impact of a single trade on the settlement price.<sup>7</sup>

The Commission finds good cause to approve the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. By accelerating the effectiveness of the CBOE's rule proposal, the Commission is ensuring that the Exchange will be able to list index options on the IPC without any interruption if the Bolsa decides to change the settlement methodology while continuing to ensure that investors are adequately informed of the changes in settlement methodology. Accordingly, the Commission believes that it is consistent with Sections 6(b)(5) and 19(b)(2) of the Act to approve the proposed rule change on an accelerated basis.

## V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) <sup>8</sup> of the Act, that the proposed rule change (File No. SR-CBOE-96-32) is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Jonathan G. Katz,  
Secretary.

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<sup>5</sup> The Commission notes that such regulatory circular should, at a minimum, specify the exact time period during which the weighted average settlement value for expiring IPC options will be calculated.

<sup>6</sup> See Securities Exchange Act Release Nos. 32120 (April 9, 1993), 58 FR 19864 (April 16, 1993) (approval order for the Financial Times-Stock Exchange 100 Index); 37089 (April 9, 1996), 61 FR 16660 (April 16, 1996) (approval order for the Nasdaq-100 Index).

<sup>7</sup> The Commission notes that if the Bolsa determines to sue a weighted average settlement methodology, the weighted average will be commuted from transaction prices over a period of time at the end of the trading day. The Commission expects, however, that once the exact time period for calculating the settlement value for IPC options is established, the CBOE will make conforming changes to its rules in accordance with Section 19(b) of the Act.

<sup>8</sup> 15 U.S.C. 78s(b)(2) (1988).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

[Release No. 34-37255; File No. SR-CHX-95-25]

**Self-Regulatory Organizations;  
Chicago Stock Exchange,  
Incorporated; Order Granting Approval  
to Proposed Rule Change, Including  
Amendment Nos. 1, 2, 3, and 4,  
Relating to the Establishment of a  
Minor Rule Violation Procedure and  
Reporting Plan**

May 30, 1996.

**I. Introduction**

On October 11, 1995, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Sections 19(b)(1) and 19(d)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rules 19b-4 and 19d-1(c)(2) thereunder,<sup>2</sup> a proposed rule change to establish a minor rule violation procedure.<sup>3</sup> On December 8, 1995, the Exchange submitted to the Commission Amendment No. 1 to the proposed rule change.<sup>4</sup> The original filing, as amended by Amendment No. 1, was published for comment in Securities Exchange Act Release No. 36576 (December 12, 1995), 60 FR 65362 (December 19, 1995). On January 17, 1996 the Exchange submitted to the Commission Amendment No. 2 to the proposed rule change, on March 5, 1996 the Exchange submitted Amendment No. 3 to the proposed rule change, and on April 17, 1996 the Exchange submitted Amendment No. 4 to the proposed rule change.<sup>5</sup> Amendment

Nos. 2, 3, and 4 were published for comment in Securities Exchange Act Release No. 37140 (April 23, 1996), 61 FR 19107 (April 30, 1996). The Commission received two comment letters on the proposal.<sup>6</sup> This order approves the proposed rule change, including amendment Nos. 1, 2, 3, and 4, and the Exchange's proposed minor rule violation reporting plan.<sup>7</sup>

**II. Description**

The Exchange proposes to adopt, as Article XII, Rule 9 of the CHX rules,<sup>8</sup> a minor rule violation procedure ("Procedure") that authorizes the Exchange, in lieu of commencing disciplinary proceeding, to impose a fine, not to exceed \$2,500, on any member, member organization, associated person or registered or non-registered employee of a member or member organization for any violation of an Exchange rule which the Exchange determines to be minor in nature. The

of rule violations that would be designated minor rule violations under the proposal and reporting plan and clarified the operation of four other rules on such list. Amendment No. 4 revised the proposal to provide for the imposition of a fine under the proposal in the event the Staff disagrees with the Minor Rule Violation Panel's recommendation that the Exchange commence a formal disciplinary proceeding, and amended language from Amendment No. 2 in light of changes to the proposal contained in Amendment No. 3.

<sup>6</sup> See Letter from C. Philip Curely, Attorney, Robinson Curely & Clayton, P.C., to Margaret H. McFarland, Deputy Secretary, SEC, dated January 5, 1996 ("Comment Letter No. 1"); Letter from C. Philip Curely, Attorney, Robinson Curely & Clayton, P.C., to Jonathan G. Katz, Secretary, SEC, dated March 7, 1996 ("Comment Letter No. 2"). See *infra* Section III, for a discussion of Comment Letter Nos. 1 and 2.

<sup>7</sup> In Securities Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23828 (June 8, 1984), the SEC adopted amendments to paragraph (c) of Rule 19d-1 to allow self-regulatory organizations ("SROs") to submit for SEC approval plans for the abbreviated reporting of minor disciplinary infractions. Under the amendments, any disciplinary action taken by a self-regulatory organization against any person for violation of a rule of the self-regulatory organization that has been designated as a minor rule violation pursuant to a plan filed with the SEC shall not be considered "final" for purposes of Section 19(d)(1) of the Act if the sanction imposed consists of a fine not exceeding \$2,500 and the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his or her administrative remedies with respect to the matter.

The SEC has approved minor disciplinary rule plans by virtually every stock exchange and the National Association of Securities Dealers, Inc. See, e.g., Securities Exchange Act Release No. 21918 (April 3, 1985), 50 FR 14068 (April 9, 1985) (File No. 4-260) (Amex); Securities Exchange Act Release No. 22415 (September 17, 1985), 50 FR 38600 (September 23, 1985) (File No. 4-284) (NYSE); Securities Exchange Act Release No. 22654 (November 21, 1985), 50 FR 48853 (November 27, 1985) (File No. 4-285) (PSE); Securities Exchange Act Release No. 32383 (May 28, 1993), 58 FR 31768 (June 4, 1993) (SR-NASD-93-06).

<sup>8</sup> The proposed rule change also renumbers existing CHX Article XII, Rule 9 to Article XII, Rule 10. See Amendment No. 1, *supra* note 4.

Committee on Floor Procedure will have the same authority for violations relating to decorum on the Exchange trading floor. The Procedure specifically states that the Committee on Floor Procedure and the Panel shall not, collectively, impose more than one fine pursuant to the Procedure relating to the same underlying violation and incident.

If the fine is to be imposed by the Exchange (as opposed to the Committee on Floor Procedure) the fine shall be imposed in accordance with the method set forth in paragraph (b) of the Procedure. Specifically, prior to imposing the fine, the staff of the Exchange shall present the facts supporting such violative conduct to a Minor Rule Violation Panel ("Panel"), which shall consist of three floor members (one member of the Committee on Floor Procedure, one member of the Committee's Rules Subcommittee, and one member not on the Committee or any of its subcommittees) appointed by the President of the Exchange. The Panel then is authorized either to impose the fine, reject the staff's recommendation, or recommend that the Exchange commence a formal disciplinary proceeding under Article XII of the CHX rules. In the event that the Panel recommends that the Exchange commence a formal disciplinary proceeding, the staff shall either issue a report to the President, in accordance with Article XII, Rule 1(a), recommending that formal changes be brought, or advise the Panel that the staff will not recommend that the Exchange commence a formal disciplinary proceeding. If the staff decides not to recommend the commencement of a formal disciplinary proceeding, the Panel is required to impose a fine in accordance with the provisions of the Procedure.

If a fine is to be imposed under the Procedure, the Exchange will serve a written statement on the person against whom a fine is imposed setting forth the rule violated, the act or omission constituting the violation, the fine imposed and the date of imposition, the date the fine must be paid and the date by which such determination must be contested, such date to be not less than 15 days after the date of service of the written statement.

If the person against whom a fine is imposed pursuant to the Procedure chooses not to contest the matter and pays the fine, he or she waives his or her right to a disciplinary proceeding under Article XII of the Exchange's rules and any right to review or appeal (to the extent such right would otherwise exist under current Exchange rules). Alternatively, any person may chose to

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

<sup>2</sup> 17 CFR 240.19b-4 and 240.19d-1(c)(2).

<sup>3</sup> The Exchange has submitted to the SEC concurrently with the proposed rule change a minor rule violation reporting plan in accordance with Rule 19d-1(c)(2) under the Act. See Letter from David Rusoff, Attorney, Foley & Lardner; to Glen Barrentine, SEC, dated October 6, 1995.

<sup>4</sup> See Letter from David T. Rusoff, Attorney, Foley & Lardner, to Glen Barrentine, SEC, dated December 8, 1995 ("Amendment No. 1").

<sup>5</sup> See Letter from David T. Rusoff, Attorney, Foley & Lardner, to Jon Kroeper, Attorney, SEC, dated January 12, 1996 ("Amendment No. 2"); Letter from David T. Rusoff, Attorney, Foley & Lardner, to Glen Barrentine, SEC, dated March 3, 1996 ("Amendment No. 3"); and Letter from David T. Rusoff, Attorney, Foley & Lardner, to John Kroeper, Attorney, SEC, dated April 17, 1996 ("Amendment No. 4"). Amendment No. 2 added a number of clarifications to the proposal, amended the Recommended Fine Schedule, and revised the proposed minor rule violation reporting plan to provide a method for modifying the list of rule violations that constitute minor rule violations under the reporting plan. Amendment No. 3 revised the proposal by removing the President of the CHX from any role in the imposition or setting aside of fines under the proposal and further amended the Recommended Fine Schedule. Amendment No. 3 also revised the proposed rule change and reporting plan by removing seven rule violations from the list

contest a fine by submitting a written answer, at which point the matter becomes a "disciplinary proceeding" subject to the applicable provisions of Article XII, including all disciplinary sanctions available thereunder (except for contests of a fine by the Committee on Floor Procedure, which will be subject to the provisions of Article XII, Rule 3).<sup>9</sup>

Under the Procedure, the Exchange will periodically prepare and announce to its members and member organizations a list of Exchange rules and policies as to which the Exchange may impose fines pursuant to the Procedure as well as the fines that may be imposed for their violation.<sup>10</sup> The Procedure, however, expressly states that the Exchange is not required to impose a fine under the Procedure with respect to any violation of any rule included on such list. In addition, whenever the Exchange determines that a rule violation is not minor in nature, it has the discretion to commence disciplinary proceedings under Article XII of the CHX rules.

The Exchange also proposes to adopt, pursuant to Section 19(d)(1) of the Act and Rule 19d-1(c)(2) thereunder, a minor rule violation reporting plan ("Plan"). Under its Plan, the Exchange designates certain specified rule violations as minor rule violations.<sup>11</sup>

<sup>9</sup> Any fine imposed under the Procedure that is contested may be publicly reported by the Exchange to the same extent that CHX disciplinary proceedings may be publicly reported. See CHX Rules, Article XII, Rule 9 (Pending Proceedings).

<sup>10</sup> The Exchange will file with the SEC, for its approval pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder, any proposed additions to, deletions from, or other modifications to either the list of rule violations set forth in Article XII, Rule 9 that are deemed to be minor rule violations or the related Recommended Fine Schedule.

As part of the proposed rule filing, the Exchange has submitted a Recommended Fine Schedule which contains recommended dollar amounts for the first, second, third and subsequent violations, as calculated on a twelve-month rolling basis, of a rule designated as a minor rule violation in the Procedure and Plan. With one exception, the recommended dollar amounts are as follows: First Violation—\$100; Second Violation—\$500; Third and Subsequent Violation—\$1,000. For violations of Article XI, Rule 4 (Financial and Operational Reports) the recommended fines will be those currently set forth in Interpretation and Policy .02 to such rule (*i.e.*, 1–30 days late—\$100; 31–60 days late—\$200; 61–90 days late—\$400).

<sup>11</sup> The Plan provides that the Exchange may make additions to, deletions from, or other modifications to the list of rule violations that constitute minor rule violations under the Plan. Rule 19d-1(c)(2) under the Act requires that the SEC approve by order, after appropriate notice of the terms of substance of the filing or a description of the subjects and issues involved and opportunity for interested persons to submit written comment, any amendment to an exchange's minor rule violation reporting plan submitted under such rule. In this regard, the Plan provides that every filing of a proposed rule change by the Exchange pursuant to

and requests that it be relieved of the current reporting requirement of Rule 19d-1(c)(1) under the Act regarding such violations, provided it gives notice of such violations to the Commission on a quarterly basis.<sup>12</sup> The Plan, however, would not cover any fine imposed pursuant to the Procedure that is contested. Such violations and fines would continue to be reported as they occur.

The Exchange has proposed a list of rule and policy violations that would be designated minor rule violations in both its Procedure and Plan:<sup>13</sup> (1) Acquisition of Membership by General or Limited Partner (Article II, Rule 1); (2) General Partners Bound by Rules of Exchange (Article II, Rule 4); (3) Notice of Death or Retirement of Partner (Article II, Rule 9); (4) Filing and Approval of Articles of Incorporation (Article III, Rule 4); (5) Authorization of Officers to Act (Article III, Rule 5); (6) Officers, Directors and Principal Stockholders (Article III, Rule 6); (7) Death or Retirement of Registrant Member (Article III, Rule 11); (8) Records of Orders Transmitted (Article IX, Rule 78); (9) Dealing in Stocks on Put, Call, Straddle or Option (Article IX, Rule 15); (10) Record of Margin Calls and Receipt of Margin (Article X, Rule 2); (11) Record of Orders (Article XX, Rule 24); (12) Written Reports of Transactions (Article XXX, Rule 5); (13) Record of Orders (Article XXX, Rule 11); (14) Financial Operational Reports (Article XI, Rule 4); (15) Notification of Change in Bond Coverage (Article XI, Rule 6); (16) Filing Requirements on Change of Examining Authority (Article XI, Rule 7); (17) Submission of Evaluation of Co-Specialists Survey (Article VIII, Rule 11); (18) Failure to Issue Intermarket Trading System ("ITS") Pre-Opening Notification (Article XX, Rule 39); (19) Failure to Comply with ITS Trade-

Section 19(b) of the Act and Rule 19b-4 thereunder that adds to, deletes from or otherwise modifies the list of rule violations contained in Article XII, Rule 9(h) of the CHX rules for which the Article XII, Rule 9 Procedure may be used will be deemed a request by the Exchange for SEC approval to modify the list of CHX rules that are designated minor rule violations for purposes of the Exchange's reporting plan pursuant to Rule 19d-1(c)(2) under the Act.

<sup>12</sup> The Exchange's quarterly report to the SEC will include: the CHX's internal file number for the case, the name of the individual and/or organization, the nature of the violation, the specific rule provision violated, the fine imposed, the number of times the rule violation has occurred, and the date of disposition.

<sup>13</sup> In Amendment No. 3, the Exchange removed seven violations from the list of violations it proposed to add to its Procedure and Plan.

<sup>14</sup> The only violation of this rule that may be considered a minor rule violation is a failure of a specialist to properly time-stamp an order ticket entrusted to him or it.

Through, Locked Markets and Block Trade Rules (Article XX, Rule 40); (20) Failure to Comply with 50% Requirement (Article XXXIV, Rule 3); (21) Failure to Comply with Public Outcry Rule (Article XXXIV, Rule 10); (22) Violation of Class A Decorum Rules (Article XII, Rule 3, Interpretation and Policy .01); (23) Violation of Class B Decorum Rules (Article XII, Rule 3, Interpretation and Policy .01); (24) Failure to Clear the Post (Article XX, Rule 10); (25) Failure to Comply with Cabinet Securities Provision (Article XX, Rule 11); (26) Failure to Comply with Minimum Fractional Changes (Article XX, Rule 22); (27) Failure to Comply with "Stopped" Order Rule (Article XX, Rule 28); (28) Improper Use of "SOLD" Designator (Article VIII, Rule 7); (29) Trading Ahead of Customer Orders (Article XXX, Rule 2); (30) Violation of Preference Solely on Competitive Basis Rule (Article XXX, Rule 3).<sup>17</sup>

### III. Comments

The Commission received two comment letters on the proposal from Robinson Curely & Clayton, P.C.<sup>18</sup> In response, the Exchange filed Amendment No. 3 to the proposal and a reply letter.<sup>19</sup> The following is a summary of the arguments raised in the comment letters, and the Exchange's response thereto.

First, in Comment Letter Nos. 1 and 2 the commenter argues that the proposal gives too much discretion to the Exchange's staff with regard to the disposition of alleged violations of CHX rules and does not provide any guidelines as to whether a formal disciplinary proceeding or the Procedure should be utilized in any particular situation. In this regard, the

<sup>15</sup> The provision of this rule that may be considered a minor rule violation is the provision that states that although oral bids and offers in securities in the cabinet are permitted, they cannot conflict with bids and offers resident in the cabinet. A violation of this provision would occur if a floor broker fails to "clear the cabinet" (*i.e.*, fails to satisfy bids or offers in the cabinet) before effecting an agency cross in a cabinet security at the same price or a price worse than the price of the bid or offer resident in the cabinet.

<sup>16</sup> The only portion of this rule that is considered a minor rule violation is the prohibition on a specialist trading for his or its own account ahead of customer orders on the specialist's book.

<sup>17</sup> The only violation of this rule that may be considered a minor rule violation is a specialist's failure to fill an incoming ITS commitment to the fullest extent possible based on orders in the specialist's book.

<sup>18</sup> See Comment Letter Nos. 1 and 2, *supra* note 6.

<sup>19</sup> See Amendment No. 3, *supra* note 5; Letter from George T. Simon, Attorney, Foley & Lardner, to Jonathan G. Katz, Secretary, SEC, dated March 4, 1996.

commenter argues that the staff could elect to initiate a formal disciplinary proceeding (with the potential for the imposition of a severe penalty and attendant publicity) if it was to its "advantage" to do so, or utilize the Procedure in order to spare a presumably favored offender such treatment. The Exchange contends that the discretion given to its staff under the Procedure is the same prosecutorial discretion currently given to the staff in deciding whether to bring disciplinary charges and approved by the Commission for use by other SROs in their minor rule violation procedures. Moreover, the CHX argues that because all fines imposed under the Procedure must be approved by the Panel, the Procedure gives less discretion to the CHX staff than that granted under the procedures utilized by other exchanges, which allow their staffs to unilaterally assess such fines.<sup>20</sup>

Second, in Comment Letter No. 1 the commenter argued that the Procedure, as originally proposed, also placed too much discretion in the hands of the CHX's President.<sup>21</sup> Furthermore, the commenter contended that the interaction of the President's role under the Exchange's existing formal disciplinary procedures and the Procedure, as originally proposed, would create an "unsound result" in a situation where the President disregarded the Panel's recommendation that the Exchange initiate a formal disciplinary action and imposed a fine under the Procedure. If the alleged violator contested the imposition of such a fine, the matter would become a formal disciplinary proceeding. Under Article XII, Rule 5(b) of the CHX rules, the President imposes the final judgment in each formal disciplinary proceeding.<sup>22</sup> The commenter claimed that in such situations the President would, in effect, sit as "trial judge and appeals court." In response, the CHX stated that this concern was resolved by Amendment

No. 3, which removed the President from any role in the Procedure; however, the Exchange also disputed the commenter's characterization of the President's role in the Procedure, as originally filed.

Third, in Comment Letter Nos. 1 and 2 the commenter contends that because any contest of a fine imposed under the Procedure converts the matter into a formal disciplinary proceeding with the potential for the imposition of more severe sanctions, the Procedure imposes a "chilling effect" on a member's ability to contest such a fine.<sup>23</sup> The CHX asserts in response that in approving the minor rule violation procedures of other exchanges, the Commission has determined that such procedures are consistent with the Act.

Finally, the commenter questioned the need for the adoption of a minor rule violation procedure by the Exchange, given the existence of the summary procedure for minor infractions of CHX rules found in Article XII, Rule 2.<sup>24</sup> The Exchange responded by submitting that the Article XII, Rule 2 summary procedure has not been designated for use in conjunction with a minor rule violation reporting plan. As a result, any summary action taken under Rule 2(a) is a "final disciplinary action," which is subject to the immediate reporting requirements of Rule 19d-1 under the Act.

#### IV. Discussion

After careful consideration of the Comment Letters and the Exchange's response thereto, the Commission has decided to approve the Exchange's Procedure and Plan. For the reasons discussed below, the Commission finds that the proposed rule change and minor rule violation reporting plan are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Sections 6(b)(1), (6), and (7), 6(d)(1) and 19(d) of the Act.<sup>25</sup>

<sup>23</sup> In Comment Letter No. 2, the commenter suggested that a means to avoid such a "chilling effect" would be to allow the Exchange not to impose a more severe sanction in a disciplinary proceeding arising out of a contested minor rule violation than the fine originally imposed under the Procedure.

<sup>24</sup> Under CHX Rules, Article XII, Rule 2(a), if in the President's judgment it appears from the staff's report filed pursuant to Rule 1(a) that an alleged violator has committed a minor infraction of the CHX Constitution or rules, the President may summarily censure and/or impose a fine of up to \$500 against such violator. The President's decision may be appealed to the Executive Committee of the Exchange, whose decision shall be final.

<sup>25</sup> 15 U.S.C. 78f (b)(1), (b)(6), and (b)(7); 78f(d)(1); and 78s(d).

#### A. Proposed Minor Rule Violation Procedure

The proposal is consistent with the Section 6(b)(6) requirement that the rules of an exchange provide that its members and persons associated with its members shall be appropriately disciplined for violation of the rules of the exchange. In this regard, the Commission believes that the proposal will provide a procedure whereby member organizations can be appropriately disciplined in those instances when a rule violation is technical and objective or minor in nature, but a sanction more serious than a warning or cautionary letter is appropriate. Furthermore, because the Procedure provides procedural rights to the person fined and permits a disciplined person to request a full disciplinary hearing on the matter, the proposal provides fair procedure for the disciplining of members and persons associated with members consistent with Sections 6(b)(7) and 6(d)(1) of the Act.

The Commission also believes that the proposal provides an alternate means by which to deter violations of the CHX rules included in the Procedure, thus furthering the Section 6(b)(1) requirement that an exchange have the ability to enforce compliance by its members and persons associated with its members with the Act and the rules of the exchange. An exchange's ability to enforce effectively compliance by its members and member organizations with Commission and exchange rules is central to its self-regulatory functions. Inclusion of a rule in an exchange's minor rule violation procedure and reporting plan should not be interpreted to mean that it is an unimportant rule. On the contrary, the Commission recognizes that inclusion of rules under a minor rule violation procedure and reporting plan not only can reduce reporting burdens of an SRO but also can make its disciplinary system more efficient in prosecuting violations of such rules.<sup>26</sup>

The Commission finds that of the 37 rules that the CHX has proposed to designate as minor rule violations in its Procedure and Plan, 28 already have been approved by the Commission for inclusion in the minor rule violation procedures and reporting plans of other exchanges.<sup>27</sup> As violations of these 28

<sup>26</sup> Relatedly, the SEC also believes that the CHX proposal to create a new Minor Rule Violation Panel to review specified minor rule violations should help to make its disciplinary system more efficient in prosecuting violations of these rules.

<sup>27</sup> Compare list of proposed minor rule violations in CHX Procedure and Plan (see *supra* text

<sup>20</sup> See, e.g., NYSE Rule 476A, Amex Rule 590, and BSE Chapter XVIII, Section 4.

<sup>21</sup> Under the Procedure, as originally proposed, if the Panel recommended that the Exchange commence a formal disciplinary proceeding in a matter brought before it, the staff would issue a report to the President pursuant to Article XII, Rule 1(a), either recommending that formal charges be brought or that the President impose a sanction in accordance with the Procedure. The President then would have had the discretion to: (i) direct the staff to prefer written charges, (ii) reject the recommendation to prefer written charges, or (iii) impose a fine under the Procedure. See Securities Exchange Act Release No. 36576 (December 12, 1995), 60 FR 65362 (December 19, 1995).

<sup>22</sup> Subject to review by the Judiciary Committee, Executive Committee and the Board of Governors. See CHX Rules, Article XII, Rule 6.

rules are amenable to quick, objective determinations of compliance and are readily adjudicated, the Commission finds that they are appropriate for inclusion in the CHX's Procedure. The Commission also finds that, for the following reasons, the other nine rules proposed to be designated as minor rule violations are appropriate for inclusion in the CHX's Procedure.

Notification of Change in Bond Coverage (Article XI, Rule 6) requires members to file with the Exchange any changes in their fidelity bond coverage. Filing Requirements on Change of Examining Authority (Article XI, Rule 7) requires members to file with the Exchange upon their withdrawal from membership in another national securities exchange or registered securities association that is the member's designated examining authority. These rules are essentially administrative reporting requirements whose violation is both objectively determinable and readily adjudicated, making them suitable for inclusion in the Exchange's Procedure.

Failure to Comply with 50% Requirement (Article XXXIV, Rule 3) requires that 50% of a CHX market maker's quarterly share volume must be in issues to which he or she is assigned.<sup>28</sup> Failure to Comply with Minimum Fractional Changes (Article XX, Rule 22) requires that bids and offers in a security may not be made at a less variation than that set in the rule.<sup>29</sup> A minor rule violation of Written Reports of Transactions (Article XXX, Rule 5) would occur, for example, if a specialist failed to supply a report of a transaction that was not effected through the Exchange's MAX System.<sup>30</sup> As with the rules discussed in the previous paragraph, violations of these rules lend themselves to quick, objective determination and adjudication. Accordingly, these rules are appropriate

for inclusion in the Exchange's Procedure.

The remaining four violations are concerned directly with the handling and execution of orders entered with Exchange members. A minor rule violation of Failure to Comply with Cabinet Securities Provision (Article XX, Rule 11) would occur if a member fails to satisfy bids or offers already resident in the cabinet before effecting an agency cross in a cabinet security at the same or worse price than that of a bid or offer in the cabinet.<sup>31</sup> The portion of Violation of Preference Solely on Competitive Basis Rule (Article XXX, Rule 3) subject to the Exchange's Procedure is a specialist's failure to fill an incoming ITS commitment to the fullest extent possible based on orders in the specialist's book.<sup>32</sup> Failure to Comply with Public Outcry Rule (Article XXXIV, Rule 10) and Failure to Clear the Post (Article XX, Rule 10) provide that market makers and floor brokers must audibly bid or offer their orders at the post before sending the order to another market or effecting an agency cross, as the cause may be.<sup>33</sup>

Although these four rules involve more substantive matters than the rules concerning reporting requirements, violations of these rules should not involve the complicated factual and interpretive issues that are present in matters that require the initiation of formal disciplinary proceedings. Moreover, the Exchange has represented to the Commission that member non-compliance with these four rules is readily determinable through the use of its surveillance mechanisms.<sup>34</sup> The Commission believes that aggressive enforcement of these rules under the Procedure should benefit investors by improving order interaction on the Exchange, while furthering member compliance with the Exchange's trading rules. Specifically, floor brokers and market makers more likely will be

encouraged to clear the post or the cabinet before effecting agency crosses or off-the-Floor transactions, thus providing a greater opportunity for the execution of orders against those already resident either with the specialist or in the cabinet. Also, specialists will be provided with an additional incentive to fill incoming ITS commitments to their stated amount, leading to the more prompt execution of orders on the specialist's book.

Although a violation of these four rules and a number of the other rules contained in the Exchange's Procedure are designed to provide important investor safeguards,<sup>35</sup> a particular violation of such rules may or may not rise to the level which would justify a formal disciplinary proceeding. Therefore, the Commission believes that including such rules in the Procedure, in light of the Exchange's discretion to bring a formal disciplinary hearing for any violation of such rules, should enhance, rather than reduce, the Exchange's enforcement capabilities regarding these rules in cases where initiation of a formal disciplinary proceeding may be more costly and time consuming in view of the minor nature of the particular violation, if not the category of violation.

In conclusion, the Commission believes that the Procedure will provide a more effective means of deterrence for the rules the Exchange proposes to include in its Procedure than would the alternative of written letters of caution for lesser violations of such rules. Accordingly, the Commission notes that the CHX retains the discretion to bring a formal disciplinary proceeding for violations of any of the rules listed in the Procedure. The Commission expects the CHX to do so when appropriate for the particular violation(s) involved, as in the cases of an egregious violation or habitual offender.

#### *B. Comments on the Minor Rule Violation Procedure*

For the reasons discussed below, the Commission believes that the Procedure, as amended, adequately addresses the concerns raised by the commenter. First, the Commission does not believe that the Procedure grants undue discretion to the staff of the Exchange in the disposition of alleged violations of CHX rules, nor that it provides inadequate guidelines as to the staff's exercise of such discretion. As the Exchange stated in its response to the Comment Letters, the addition of the

following footnote 13 for such list), with lists of minor rule violations contained in NYSE Rule 476, Amex Rule 590, and PSE Rule 10.13.

<sup>28</sup> The Commission notes that it already has approved for use in the Philadelphia Stock Exchange, Inc.'s minor rule violation and reporting plan an analogous rule that pertains to registered options traders ("ROTs"). See Securities Exchange Act Release No. 23491 (August 1, 1986), 51 FR 28469 (August 7, 1986) (File No. 4-289). Specifically, Phlx Option Floor procedure Advice B-3 requires, among other things, that at least 50% of each ROT's trading activity in each quarter must be in assigned options.

<sup>29</sup> E.g., for every security priced above \$1.00, no less than a 1/8 per \$1.00 variation is permissible.

<sup>30</sup> Telephone conversation between David Rusoff, Attorney, Foley & Lardner; Daniel Liberti, Manager, Market Regulation, and Rick Ose, Market Regulation, CHX; and Glen Barentine and Jon Kroeper, SEC, on February 28, 1996.

<sup>31</sup> See *supra* note 15.

<sup>32</sup> See *supra* note 17.

<sup>33</sup> See Amendment No. 3, *supra* note 5.

<sup>34</sup> The Exchange's floor staff can determine whether the cabinet securities provision has been violated through a comparison of executions in such securities with orders resident in the book. Violations of precedence to orders in the book can be determined through a comparison of ITS commitments, executions thereof on the Exchange, and subsequent specialist executions. Telephone conversation between David T. Rusoff, Attorney, Foley & Lardner, and Jon Kroeper, Attorney, SEC, dated May 24, 1996. Violations of the two provisions concerning clearing the post can be determined by discerning whether the floor broker or market maker's order ticket was stamped with the distinctive identifier of the time stamp machine at the specialist's post, or through a conversation with the specialist in question. For a more complete discussion of the determination of clearing the post violations, see Amendment No. 3, *supra* note 5.

<sup>35</sup> E.g., Trading Ahead of Customer Orders (Article XXX, Rule 2) and Failure to Comply with "Stopped" Order Rule (Article XX, Rule 28).

Procedure gives its staff the same prosecutorial discretion as that approved by the Commission for use by other SROs in their minor rule violation procedures. In addition, the Procedure limits the staff's discretion by requiring that the Panel impose all fines against alleged violators. Moreover, as has been noted above, the Procedure is to be utilized in situations where a rule violation is technical and objective or minor in nature; the Commission expects that the Exchange will resolve more serious violations of such rules through the use of formal disciplinary proceeding. The Comment Letters make the related argument that the availability of the Procedure opens the possibility that the Exchange could abuse its discretion and utilize either the Procedure or full disciplinary proceedings depending upon the identity of the alleged violator. The Commission believes that this concern is alleviated by the Commission's ability to review the disciplinary actions taken by the Exchange through both the CHX's formal reporting under Rule 19d-1 and proposed quarterly reporting under the Plan, and as part of the Commission's regular oversight inspections of the Exchange.

Second, the Commission notes that the commenter's concern that the roles of the CHX's President, under the Exchange's existing disciplinary procedures and the Procedure, as originally filed, would create an unsound result has been rendered moot by the removal in Amendment No. 3 of any role on the part of the President in the imposition of fines under the Procedure.

Third, the commenter argues that because any contest of a fine imposed under the Procedure converts the matter into a formal disciplinary proceeding with the potential for the imposition of more severe sanctions, the Procedure imposes a chilling effect on a member's ability to contest such a fine. The Commission believes that the commenter's argument is misplaced. The availability of a minor rule violation procedure benefits not only an exchange, for the reasons noted above, but alleged violators of rules deemed minor rule violations as well. In having the ability to pay a fine assessed under a minor rule violation procedure instead of being subject to the initiation of formal disciplinary procedures as a matter of course, an alleged violator has the opportunity to avoid the expenditure of time and resources, as well as the attendant publicity, that a formal disciplinary proceeding may entail. An alleged violator receives these benefits while retaining his or her due

process rights to contest the charges in a formal disciplinary proceeding.

As for the commenter's suggestion that the Exchange could prevent such a "chilling effect" by amending the proposed rule change to provide that no more severe sanction could be imposed in any formal disciplinary proceeding arising out of a contest of a minor rule violation fine than that originally imposed under the Procedure, the Commission believes that such a provision would limit unduly the Exchange's discretion to impose what it believed were appropriate sanctions as a result of the findings it made with regard to a matter in a formal disciplinary proceeding.<sup>36</sup>

Finally, the commenter questions the necessity for the Procedure given the existence of summary disciplinary procedures in Article XII, Rule 2(a) of the Exchange's rules. The Commission does not believe that an Exchange's ability to adopt a minor rule violation procedure and reporting plan should be limited by the existence of other summary procedures in an exchange's rules. Additionally, the Commission notes that the Article XII, Rule 2(a) procedure is incompatible with a minor rule violation reporting plan, as any proceeding under Rule 2(a) is considered a formal disciplinary proceeding under CHX rules, making any action taken under these procedures a "final disciplinary action" under Rule 19d-1, and therefore immediately reportable to the Commission.

### C. Minor Rule Violation Reporting Plan

In adopting Rule 19d-1, the Commission noted that the Rule was an attempt to balance the informational needs of the Commission against the reporting burdens of the SROs.<sup>37</sup> In promulgating paragraph (c)(2) of Rule 19d-1, the Commission attempted to reduce the reporting burdens of the SROs by permitting, where immediate reporting was unnecessary, periodic reporting of minor rule violations.<sup>38</sup>

<sup>36</sup> Specifically, in the context of a formal disciplinary proceeding the Exchange has the ability to discipline its members and any persons associated with a member "by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member or any other fitting sanction." See CHX Rules, Article XII, Rule 8(a). As the Panel may only impose monetary fines under the Procedure, the commenter's proposal could restrict the Exchange to imposing such fines in formal disciplinary proceedings arising out of appeals of minor rule violations, thus depriving the Exchange of the opportunity to impose what may be a more appropriate sanction in light of its findings in a formal hearing.

<sup>37</sup> See Securities Exchange Act Release No. 13726 (July 8, 1977), 42 FR 36411 (July 14, 1977).

<sup>38</sup> See Securities Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23828 (June 8, 1984).

Any minor rule violation reporting plan adopted pursuant to Rule 19d-1(c)(2) is intended to be limited to rules which relate to areas that can be adjudicated quickly and objectively.

The Commission believes that the rules proposed to be deemed minor rule violations under the Exchange's Plan meet this criteria for the same reasons as noted above with regard to the rules proposed for inclusion in its Procedure.<sup>39</sup> Violations of these rules are amenable to quick and objective determinations of compliance. Efficient and equitable enforcement of violations of these CHX rules should not entail the complicated factual and interpretive inquiries associated with more sophisticated Exchange disciplinary actions. Therefore, it is reasonable for these rules to be included in such an abbreviated periodic reporting plan.<sup>40</sup> In addition, the Commission finds that the format proposed by the Exchange to make its quarterly report of violations to the Commission under the Plan is identical, in all material respects, to the minor rule violation reporting plans approved by the Commission for use by other exchanges, and thus in compliance with the requirements of Rule 19d-1(c)(2) under the Act.

### V. Conclusion

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act<sup>41</sup> and Rule 19d-1(c)(2) thereunder, that the proposed rule change (SR-CHX-95-25) and minor rule violation reporting plan of the Exchange is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>42</sup>

Jonathan G. Katz,

Secretary.

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<sup>39</sup> See *supra* Section IV.A.

<sup>40</sup> Although the CHX Board of Governors makes the initial determination of whether an Exchange rule violation is "minor" for purposes of inclusion in new Article XII, Rule 9 and the Plan, this determination is subject to SEC review pursuant to Sections 19(b)(1) and (d)(1) of the Act and Rules 19b-4 and 19d-1(c)(2) thereunder. The SEC notes that Article XII, Rule 9 fines in excess of \$2500 are not considered assessed pursuant to the Plan and, accordingly, must be reported on an immediate basis to the SEC under Section 19(d)(1) of the Act and Rule 19d-1 thereunder.

<sup>41</sup> 15 U.S.C. 78s(b)(2)

<sup>42</sup> 17 CFR 200.30-3(a)(12) and (a)(44).