

[Release No. 34-37651; File No. SR-CBOE-96-24]

Self-Regulatory Organizations; Order Approving a Proposed Rule Change by the Chicago Board Options Exchange, Inc.; Relating to As of Add Submissions

September 5, 1996.

On April 15, 1996, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to terminate its fee program for members who, for more than a prescribed percentage of transactions, submit trade information pursuant to CBOE Rule 6.51 ("Reporting Duties") after the date on which the trade is executed. (These post-trade date submissions are commonly referred to as "as of adds.") In conjunction with the foregoing, the Exchange also proposes to revise the structure of its as of add summary fine program.

Notice of the proposal was published for comment and appeared in the Federal Register on May 17, 1996.³ No comment letters were received on the proposal. This order approves the CBOE's proposal.

I. Description of the Proposal

CBOE Rule 6.51 requires, among other things, that (i) a participant in each transaction to be designated by the Exchange shall immediately report the transaction to the Exchange and (ii) each business day, each clearing member shall file with the Exchange trade information covering each Exchange transaction made by it or on its behalf during the business day.

On October 1, 1993, the Exchange instituted an as of add fee program to collect fees from members who, for more than a prescribed percentage of transactions, submit trade information pursuant to Rule 6.51 after the date on which the trade is executed. This program is set forth in CBOE Rule 2.26 and currently functions in the following manner. Each individual member is assessed a \$10.00 fee for each as of add submitted by the member during a given month that is in excess of 2.4% of the member's trade submissions during that month. Similarly, each clearing member is assessed a \$3.00 fee for each as of add submitted by the clearing member

during a given month that is in excess of 1.2% of the clearing member's trade submissions during that month. In addition, the total fees under the program that may be assessed against a member in a given month are capped at \$500 for individual members and at \$1,000 for clearing members.

The reason the Exchange implemented the as of add fee program was to allocate the costs borne by the Exchange in processing as of add submissions to those members most responsible for generating those costs and thereby to encourage the submission of information with respect to a trade on the date the trade is executed by creating an economic incentive to submit the information on that day. The Exchange represents that during the first year of the program, the percentage of as of add submissions declined by 10% even though the Exchange experienced a 37% increase in trading volume. Based on past experience, the Exchange estimates that had the program not been in effect during that time period, the percentage of as of add submissions would have doubled. Since November, 1994, however, the percentage of as of add submissions has remained relatively constant. Therefore, although the program has clearly been effective in reducing the percentage of as of add submissions, it no longer appears to be causing a reduction in the rate of those submissions.

Accordingly, the Exchange is proposing to terminate the as of add fee program and to seek further reductions in the percentage of as of add submissions by revising the structure of the Exchange's as of add summary fine program.⁴

The Exchange institute its as of add summary fine program on February 1, 1995. The program is a part of the Exchange's minor rule violation plan ("Minor Rule Plan") and is set forth in CBOE Rule 17.50(g)(7). Under the program, any individual member whose

monthly percentage of as of add submissions exceeds 7.2% for two consecutive months or any clearing member whose monthly percentage of as of add submissions exceeds 3.6% for two consecutive months is subject to a fine of \$250 for the first offense, \$500 for the second offense, and \$1,000 for each subsequent offense occurring during any 12-month period.

The Exchange is proposing to revise the structure of the as of add summary fine program in four primary respects in order to encourage further change in as of add behavior, and to the extent the Exchange collects fines under the program, to help the Exchange defray the additional costs it incurs in processing as of add submissions.

First, the Exchange is proposing to replace the current as of add summary fine schedule for individual members. The proposed fine schedule would be stricter in two respects: (i) Action against an individual member under the fine schedule would be triggered when the member exceeds the maximum allowable as of add submission percentage in a given month instead of when the member exceeds that percentage in two consecutive months as is the case under the current fine schedule and (ii) the maximum allowable as of add submission percentage for individual members under the fine schedule would be reduced from its current level of 7.2% to 5%. Specifically, the current fine schedule for individual members would be replaced with the following fine schedule. Any individual member whose percentage of as of add submissions in any month exceeds 5% would receive a letter of information for the first offense, a letter of caution for the second offense, a \$500 fine for the third offense, a \$1,000 fine for the fourth offense, and would be referred to the Exchange's Business Conduct Committee for each subsequent offense occurring during any 12 month period.⁵

In addition, as is currently the case, the Exchange would retain the discretion to initiate a formal disciplinary proceeding against an

⁴ The Exchange now believes that the costs to the Exchange of administering a program that imposes small fees or fines on occasional late-reporting members is not justified. Instead, the focus of the new program is on a small number of chronic late reporters who appear to be willing to accept fines as a cost of doing business. The proposed program would permit the Exchange to bring these chronic violators of trade reporting requirements before the CBOE's Business Conduct Committee much sooner than would be permitted under the existing program. This could result in formal charges being brought against such violators, which could lead to very severe sanctions such as major fines and suspensions of membership. See Letter from Michael L. Meyer, Esq., Schiff, Hardin & Waite, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated August 6, 1996 ("Clarification Letter").

⁵ In some respects the proposed fine schedule is less strict. Under the proposed fine schedule, a member would not receive any monetary sanction for the first two offenses, as compared to the existing schedule where a member is fined \$250 and \$500 for the first and second offenses, respectively. Moreover, because the Exchange is proposing to eliminate the as of add fee program, the monetary disincentive for as of adds will be reduced for all individual members except those relatively small number of chronic late reporters whom the Exchange has chosen to target. This is consistent with the Exchange's stated purpose of focusing on the chronic late reporters who appear to be willing to accept fines as a cost of doing business. See Clarification Letter, *supra* note 4.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 37201 (May 10, 1996), 61 FR 24986 (May 17, 1996).

individual member pursuant to Chapter XVII of the Exchange's rules in the event the Exchange determines that any violations of Rule 6.51 are not minor in nature.

Second, the current as of add summary fine schedule for clearing members would be deleted and going forward as of add summary fines would only be assessed against individual members. The Exchange believes that such a fine structure is appropriate because individual members have primary control over the timing of trade submissions, and in the Exchange's experience, most as of adds are caused by delays and errors of individual members. Moreover, the Exchange believes that clearing members generally have a greater economic incentive than individual members to reduce as of adds because clearing members incur personnel and systems costs due to the extra work necessary to process as of adds whereas individual members do not incur such costs. Therefore, the Exchange believes that the most effective manner in which to achieve a reduction in the percentage of as of adds is to direct the as of add summary fine program toward individual members. Of course, notwithstanding the foregoing, the Exchange would still have the ability to initiate a formal disciplinary proceeding against a clearing member for violations of Rule 6.51.

Third, the Exchange is proposing to implement a verification procedure under Rule 17.50 pursuant to which any member who receives an as of add summary fine would be able to request verification of that fine by the Exchange. Under this procedure, the Exchange would attempt to serve any member who incurs an as of add summary fine with a disciplinary notice on or before the 10th day of the month immediately following the month in which the fine is incurred. The member would then have until the 25th day of the month in which the disciplinary notice is served to request verification. After the Exchange's verification process is completed, it would notify the member in writing of the Exchange's determination, and if the member so desired, the member could appeal the fine within 30 days after the date of such notice in accordance with the appeal procedures under Rule 17.50(d). In addition, any member who incurs an as of add summary fine and does not request verification would be able to appeal the fine under Rule 17.50(d) within 30 days after the Exchange's service of the disciplinary notice informing the member of the fine. The above-described verification procedures would function in the same general

manner as the verification procedures that are currently in place under Rule 17.50 for fines imposed for failure to submit accurate trade information and for failure to submit trade information to the price reporter, and these procedures would serve to replace the current as of add verification procedures under Rule 2.26(c) which would be eliminated under the proposed rule change along with the remainder of Rule 2.26.

Finally, the current procedures set forth in Rule 2.26(d) which permit the Exchange to suspend the as of add fee program would also be eliminated along with the remainder of Rule 2.26, and instead, would be restated in Rule 17.50 and made applicable to the as of add summary fine program. As is currently the case with respect to the as of add fee program, these procedures would permit the Exchange's Clearing Procedures Committee, with the approval of the President of the Exchange, or his designee, to suspend the as of add summary fine program for periods no greater than seven calendar days, plus extensions, when unusual circumstances affect the ability of a significant number of members to submit trade information on a timely basis.

The Exchange proposes to implement the proposed rule change within 45 days after its approval by the Commission. The purpose of this time interval is to give the Exchange the opportunity to inform members of the approval of the proposed rule change in the Exchange's Regulatory Bulletin before the rule change is put into effect. The Exchange will publish the effective date of the rule change in the Exchange's Regulatory Bulletin and will notify the Commission of the effective date by letter.

II. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, the requirements of Section 6(b)(5).⁶ Specifically, the Commission believes that the proposed rule change may serve to further reduce the total number of monthly as of add submissions by providing a clear sanction in those circumstances in which disciplining is clearly appropriate. As a result, the Commission believes that the proposal should benefit all Exchange members, and ultimately investors, by reducing the Exchange's processing costs, making the CBOE more efficient in terms of the

time involved in trade processing, and reducing the risk exposure to investors and Exchange member firms.

The Commission believes that an exchange's ability to effectively enforce compliance by its members and member organizations with Commission and exchange rules is central to its self-regulatory functions. In this regard, the Commission finds that the CBOE's proposal also is consistent with Section 6(b)(6)⁷ of the Act in that it provides for the appropriate disciplining of the CBOE's members for violation of Exchange rules. Indeed, the Commission previously urged the CBOE to incorporate the as of add fee program into the Minor Rule Plan contained in Rule 17.50.⁸ The Commission continues to believe that fining and instituting disciplinary proceedings against members to encourage compliance with exchange rules is generally preferable to assessing fees.⁹

The Commission finds that the proposed schedule of penalties pursuant to CBOE Rule 17.50(g)(7) is consistent with the Act.¹⁰

Further, the Commission does not believe that the fact that the new fine schedule will apply to individual members and not clearing members raises significant regulatory concerns. First, the Exchange represents that most as of adds are the result of late submissions by individual members, not clearing firms. Second, in its present form as previously approved by the Commission, both the as of add fee program and the summary fine program distinguish between clearing members and individual members. Accordingly,

⁷ 15 U.S.C. 78f(b)(6).

⁸ While the CBOE did not completely incorporate the as of add fee program into Rule 17.50, it did create the current summary fine program for the most egregious violations of Rule 6.51. See Securities Exchange Act Release No. 35297 (January 30, 1995), 60 FR 7091 (February 6, 1995).

⁹ See Securities Exchange Act Release No. 35190 (January 3, 1995), 60 FR 3008 (January 12, 1995). Fines levied pursuant to the Minor Rule Plan provide for an appropriate response to minor violations of Exchange rules, while preserving the due process rights of the party accused through specified, required procedures.

¹⁰ The Commission notes that under certain circumstances the new schedule of penalties pursuant to the Minor Rule Plan may be too lenient in that referral to the Business Conduct Committee takes a minimum of five months. However, the Commission's concerns in this regard are alleviated by the fact that at any time the Exchange has the discretion to initiate a formal disciplinary proceeding against a member pursuant to Chapter XVII of the CBOE's rules in the event the Exchange determines that any violations of Rule 6.51 are not minor in nature. Moreover, the Exchange has represented to the Commission that the new schedule of penalties was the subject of extensive consideration by the Exchange's Clearing Procedures and Financial Planning Committees as well as its Floor Directors Committee. See Clarification letter, *supra* note 4.

⁶ 15 U.S.C. 78f(b)(5).

the Commission believes that the difference in treatment between clearing members and individual members is reasonable and consistent with the Act.

Additionally, the Commission believes that including a verification procedure under Rule 17.50, pursuant to which any member who receives an as of add summary fine would be able to request verification of that fine by the Exchange, provides adequate due process rights to the fined member and is consistent with the Act. The Commission notes that even if the accused fails to request verification, the member may appeal the fine under Rule 17.50(d) within 30 days after the Exchange's service of the disciplinary notice informing the member of the fine.

Moreover, the Commission believes that the procedures currently set forth in Rule 2.26(d), which permit the Exchange to suspend the as of add fee program, are just as appropriate for inclusion in the as of add summary fine program. The Commission believes that when unusual circumstances exist that affect the ability of a significant number of members to submit trade information to the Exchange in a timely manner it may not be appropriate to assess fines against such members. These procedures will permit the CBOE's Clearing Procedures Committee, with the approval of the President of the Exchange, or his designee, to suspend the as of add summary fine program for periods no greater than seven calendar days, plus extensions, when unusual circumstances so warrant. The Commission notes, however, that it expects the CBOE to use its power to waive as of add fines only in highly unusual circumstances.

Finally, the Commission believes that the Exchange will be providing adequate notice of the rule change to its members by publication in the Exchange's Regulatory Bulletin 45 days in advance of the effective date of the change. The Commission believes this is particularly important with rule changes such as this which affect members' susceptibility to disciplinary sanctions.

Accordingly, the Commission finds that the CBOE's proposal is appropriate and consistent with the Act.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹¹ that the proposed rule change (SR-CBOE-96-24) is approved.

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

Margaret H. McFarland,
Deputy Secretary.
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[Release No. 34-37644; File No. SR-CHX-96-21]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to "Stop" Orders and "Stopped" Orders

September 5, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on July 22, 1996, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization.¹ The Commission is publishing this notice to solicit comments on the proposed rule change and Amendment No. 1 thereto from interested persons.

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

The Exchange proposes to amend Article XX, Rule 28 and Article XX, Rule 37 of the Exchange's Rules and add Article XX, Rule 28A to the Exchange's Rules. The text of the proposed rule change is as follows [new text is italicized; deleted text is bracketed]:

Article XX

Liability for ["Stop"] "Stopped" Orders

Rule 28 An agreement by a member or member organization to have an order "*stopped*" ["stop" securities]] at a specified price shall constitute a guarantee of the purchase or sale by him or it of the security[ies] at the *stopped* price or its equivalent in the amount specified; *but in no event shall the guarantee be greater than the greater of (i) the size disseminated in the primary market at the time the order was stopped, or (ii) the size disseminated by the Exchange at the time the order was stopped.* If an order is executed at a price less favorable [price than that agree upon] *than the stopped price*, the member or member organization which agreed to stop the securities shall be liable for an adjustment of the difference between the two prices.

¹ See Letter from David T. Rusoff, Attorney, Foley & Lardner, to Jon Kroeper, Attorney, SEC, dated August 27, 1996 ("Amendment No. 1"). Amendment No. 1 added language clarifying the manner by which sell stop limit orders would be elected under proposed CHX Article XX, Rule 28A(b)(2) and corrected the text of the proposed amendment to CHX Article XX, Rule 37(a)(6).

Rule 28A Stop Orders.

(a) Stop Orders.

A "*stop*" order to buy shall only be entered at a price above the current primary market offer. A "*stop*" order to sell shall only be entered at a price below the current primary market bid. Once entered, a "*stop*" order may not be executed until a trade (the "*effective trade*") occurs in the primary market that is at or through the price of the "*stop*" order. Once the effective trade occurs, the "*stop*" order shall be executed based upon the next primary market trade, but at a price no better than the effective trade (i.e. the "*stop*" order shall be executed on a next-no better basis).

(b) Stop Limit Orders.

(1) *Buy Stop Limit Orders.* A buy stop limit order shall only be entered at a price above the current primary market offer and shall become a limit order when a round-lot transaction takes place in the primary market at or above the stop price. The order shall then be filled in the manner prescribed for handling a limit order to buy.

(2) *Sell Stop Limit Orders.* A sell stop limit order shall only be entered at a price below the current primary market bid and shall become a limit order when a round-lot transaction takes place in the primary market at or below the stop price. The order shall then be filled in the manner prescribed for handling a limit order to sell.

Article XX

Rule 37(a)

1.-5. No change in text.

6. Since executions are guaranteed on the basis of the size and price of the best bid or offering, the order may be executed out of the primary market range for the day, but in a Dual Trading System issue a stop must be granted if requested.

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 self-regulatory organization 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 self-regulatory organization 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 primary purpose of the proposed rule change are to clarify that the existing Rule 28 of CHX Article XX relates to "stopped" orders and not "stop" orders, and to add a provision to the Exchange's Rules relating to "stop"

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).