[File No. 1–11150]

Issuer Delisting; Notice of Application To Withdraw From Listing and Registration; (Urohealth Systems, Inc., Common Stock, $.001 Par Value; Stock Purchase Rights; Warrants To Purchase Common Stock)

December 16, 1996.

Urohealth Systems, Inc. (''Company'') has filed an application with the Securities and Exchange Commission (''Commission''), pursuant to Section 12(d) of the Securities Exchange Act of 1934 (''Act'') and Rule 12d2–2(d) promulgated thereunder, to withdraw the above specified securities (''Securities'') from listing and registration on the American Stock Exchange, Inc. (''Amex'').

The reasons alleged in the application for withdrawing the Securities from listing and registration include the following:

According to the Company, its Board of Directors unanimously approved resolutions on October 1, 1996 to withdraw the Securities from listing on the Amex and instead, to list the Securities on the National Association of Securities Dealers Automated Quotations National Market System (''Nasdaq/NMS'').

The decision of the Board followed a through study of the matter and was based upon the belief that listing the Securities on the Nasdaq/NMS will be more beneficial to the Company's stockholders than the present listing on the Amex because:

The Board anticipates additional market coverage by institutional investors and greater market support among analysts and an increase in liquidity of the Company's Common Stock and Warrants will result from the transfer to the Nasdaq/NMS.

Any interested person may, on or before January 8, 1997 submit by letter to the Secretary of the Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, facts bearing upon whether the application has been made in accordance with the rules of the exchanges and what terms, if any, should be imposed by the Commission for the protection of investors. The Commission, based on the information submitted to it, will issue an order granting the application after the date mentioned above, unless the Commission determines to order a hearing on the matter.

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

Jonathan G. Katz,

Secretary.

[FR Doc. 96–32284 Filed 12–19–96; 8:45 am]

BILLING CODE 8010–01–M

[Release No. 34–38054; File No. SR–CBOE–95–48]

Self-Regulatory Organizations: Chicago Board Options Exchange, Inc.; Order Approving a Proposed Rule Change Relating to the Use of Proprietary Brokerage Order Routing Terminals on the Floor of the Exchange

December 16, 1996.

I. Introduction

On August 25, 1995, the Chicago Board Options Exchange, Inc. (''CBOE'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposal relating to the use of proprietary brokerage order routing terminals on the floor of the Exchange. On October 3, 1995, the Exchange filed Amendment No. 1 to its proposal.[3] The proposed rule change was published for comment and appeared in the Federal Register on October 13, 1995.[4] Three comment letters were received.[5] The CBOE responded to the November 1995 Comment Letter.[6] This order approves the proposal.

[1] 15 U.S.C. § 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4 (1994).

[3] Letter from Burton R. Rissman, Shiff Hardin & Waite, to Francois Mazur, Attorney, Office of Market Supervision (''OMS''), Division of Market Regulation (''Division''), dated October 3, 1995 (''Amendment No. 1'').

[4] *See* Securities Exchange Act Release No. 36332 (October 4, 1995), 60 FR 53442.

[5] Letters from David C. Bohan, Jenner & Block, writing on behalf of Interactive Brokers Inc. (''IBI''), to Jonathan G. Katz, Secretary, Commission, dated November 2, 1995 (''November 1995 Comment Letter''), and February 1, 1996 (''February 1996 Comment Letter''). IBI submitted a comment letter on November 6, 1996 withdrawing its opposition to the rule filing but reserving its right to comment further on the scope of activity permitted by CBOE to users of proprietary brokerage order routing terminals. *See* Letter from Thomas Peterffy, Chairman, IBI, to Howard L. Kramer, Senior Associate Director, Division, Commission, dated November 6, 1996 (''November 1996 Letter'').

[6] Letter from Charles J. Henry, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated January 16, 1996 (''CBOE Response Letter'').

II. Description of the Proposal

A. Introduction

The rule change approved today adopts a policy pursuant to CBOE Rule 6.23 [7] that will allow the use of a proprietary brokerage order routing terminal and its related system (''Terminal'') in the S&P 500 Index (''SPX'') options trading crowd. Written Exchange approval will be required prior to a member establishing, maintaining, or using a Terminal. The Exchange will not approve a Terminal unless and until the member who proposes to establish one on the floor of the Exchange has filed with the Exchange an ''Application & Agreement for Brokerage/Order Routing Terminals in Trading Crowds'' (''Application Agreement''), and Terminals could be used only in the crown trading SPX options to route orders in SPX options.[8]

The rule change also specifies the permitted order-routing uses of Terminals in light of a pending application which seeks Exchange approval to establish and use a Terminal in the SPX options crowd.[9] The firm's proposed Terminal would be a wireless, hand-held device designed to receive orders entered by the firm or its customers from off the floor. Use of the Terminal would enable the firm and its customers to transmit orders electronically from off the trading floor to one or more of its floor brokers on the floor of the Exchange, including to a broker who is in the trading crowd. The firm's application for use of a Terminal, which is the only such application that has been received to date by the Exchange, has raised a number of issues that the Exchange has determined to resolve as a matter of policy that will be applicable to all members in connection with its proposal to allow Terminals in the SPX options crowd. The policy primarily is contained in the Application Agreement, as described below.

B. Surveillance, Audit Trails and Compliance

Paragraph D of the Application Agreement will require an applicant to agree that the use of its Terminal will conform to all applicable laws, the rules, policies and procedures of the

[7] CBOE Rule 6.23 provides that no member shall establish or maintain any telephone or other wire communications between his or its office and the Exchange without prior approval by the Exchange. The Exchange may direct discontinuance of any communication facility terminating on the floor of the Exchange.

[8] *See infra* note 10.

[9] The firm that submitted the application, which is IBI, has been approved for membership by the CBOE.

Commission and the Exchange, and the provisions of the Application Agreement. Paragraph F of the Application Agreement will require an applicant to agree that the operation and use of all aspects of its Terminal and all orders entered through the Terminal will be subject to inspection and audit by the Exchange at any time upon reasonable notice. It also will require the applicant to furnish the Exchange with such information as the Exchange may request concerning the Terminal.

C. Physical, Electrical and Communications Requirements

The Application Agreement will require an applicant to specify the necessary physical, electrical and communication requirements of its proposed Terminal and to describe its Terminal system in detail. Paragraph H of the Application Agreement will require the applicant to coordinate the installation, maintenance and use of the Terminal on the trading floor through the Exchange's Telecommunications Department, and Paragraph K permits the Exchange to reallocate the space allocated to the applicant's Terminal. Moreover, although the Exchange will not immediately require the Terminals to interface with other Exchange systems (such as the Exchange trade match and price reporting systems), Paragraph K of the Application Agreement will allow the Exchange to require such interfaces in the future.

D. Market Making Restriction

Paragraph C of the Application Agreement will require an applicant to agree that its Terminal will be used to receive brokerage orders only, and that it will not be used to perform a market making function. Any system used to operate the Terminal must be separate and distinct from any system that may be used by the applicant or its associated persons in connection with market making. For purposes of Paragraph C, orders initiated from off the floor of the Exchange that are not counted as ''market maker transactions'' within the meaning of Exchange Rule 8.1 and that do not create a pattern of offering in the aggregate either to make two-sided markets or simultaneously to represent opposite sides of the market in any class of options are not deemed to be used to perform a market making function.

According to the Exchange, the speed with which Terminals could be used to transmit orders directly to the point of the trade on the Exchange floor could make it possible for persons not subject to Exchange control to perform market making functions from off the floor of the Exchange without being burdened by the cost of maintaining an Exchange membership, or the obligations imposed on Exchange market makers. CBOE expressed concern that if Terminals can be used to perform market making functions from off the floor of the Exchange, it may become undesirable for Exchange market makers to continue to assume the costs and obligations associated with being a registered market maker, which in turn could harm the liquidity and quality of the Exchange's market.

E. Use of Information

Paragraph E of the Application Agreement will require an applicant to agree that neither it nor its associated persons (as defined in the Application Agreement) will trade with orders transmitted through the Terminal, except in two limited situations as described below. First, an applicant or an associated person would be able to trade with an order in the Terminal system if no one else wanted to trade with it (*i.e.*, the member is the contra-party of last recourse). Second, an applicant or an associated person would be able to participate in the order on the same basis that other market makers who do not have priority participate. Under this exception to the trading restriction, the member or an associated person may trade with an order as long as (a) the member in the trading crowd who is the first to respond to such order (other than the applicant or an associated person) has priority in taking the other side of such order, and (b) the aggregate portion of such order taken by the applicant and associate persons is not greater than the portion of the order taken by every other Exchange market maker in the crowd who wishes to participate in the order in the same aggregate quantity. Paragraph E also will prohibit an applicant or an associated person from using for their own benefit any information contained in any order in the Terminal system until that information has been disclosed to the trading crowd.

F. Termination

Paragraph L of the Application Agreement allows the Exchange, upon 30 days notice, to terminate all approvals for Terminals in trading crowds on the CBOE floor or at particular posts. In addition, if the CBOE gives a member notice that any statement in a member's Application Agreement is inaccurate or incomplete, that the member has failed to comply with any provision of the Application Agreement, or that the operation of the Terminal is causing operational difficulties on the floor of the Exchange, the member normally would have seven calendar days to address the matter. The CBOE Office of the Chairman may then determine to terminate summarily the operation of that member's Terminal. Paragraph L does not affect a member's right to seek relief pursuant to Chapter XIX of the Exchange's Rules (Hearings and Review).

G. Initial Scope of the Proposal

Initially, the Exchange proposes to limit the use of Terminals to the SPX options trading crowd for routing of orders in SPX options. The Exchange stated that this limitation should give it the opportunity to observe how the Terminals are being used in a crowd which is active enough to bring to light any unforeseen problems and to gain experience with the use of Terminals in that trading crowd before floor-wide implementation of the policy were to occur.[10]

III. Summary of Comments

A. November 1995 Comment Letter

In its November 1995 Comment Letter, IBI expressed support for the proposal's aim to open the SPX pit to the Terminals, but objected to Paragraph C of the Application Agreement that would prohibit a Terminal from being used to perform a market making function. IBI interpreted Paragraph C to prohibit the use of Terminals to receive two-sided limit orders. IBI requested the Commission to commence disapproval proceedings with respect to the prohibition against the receipt of two-sided limit orders for a number of reasons. First, IBI argued that Paragraph C is overly broad because it effectively would prohibit an investor from occasionally using a Terminal to enter two-sided limit orders. IBI noted that although Paragraph C purported to ban only two-sided limit orders that created a pattern of offering in the aggregate either to make two-sided markets or simultaneously to represent opposite sides of the market, CBOE provided no guidelines that would enable a member firm to determine when a combination of buy and sell orders would establish a pattern, and would even prohibit buy and sell orders represented by the member from different customers. Second, IBI argued it would be impractical for a floor broker to determine whether its customers are performing a market making function. In this context, IBI noted that the Terminal

[10] The Commission notes that any decision to extend the policy floor-wide would have to be submitted to the Commission as a proposed rule change pursuant to Section 19(b) of the Act.

identifies the firm transmitting the order, but not the customer. Accordingly, the only way a floor broker could ensure it was not performing a market making function would be to restrict orders to buy or sell sides only. Third, because Terminal users would be restricted from entering certain two-sided limit orders, whereas other customers and brokers using telephones or other means to place such orders would face no similar restrictions, IBI claimed the provision is inconsistent with Section 6(b)(5) of the Act which requires that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Fourth, IBI argued the proposal would place an unnecessary burden on competition by limiting ''quote competition.'' IBI argued that because two-sided limit orders can result in narrower spreads, improved liquidity, and better executions, the restriction is inconsistent with the requirement of Section 6(b)(8) of the Act that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Fifth, IBI argued that the proposal would inhibit price discovery and better executions for customers, inconsistent with requirements set forth in Section 6(b)(5) of the Act that the rules of an exchange remove impediments to and perfect the mechanism of a free and open market. Sixth, IBI also maintained that the proposal is inconsistent with Section 11A(a) of the Act concerning economically efficient execution of securities transactions, fair competition, and best execution. IBI noted that the Act acknowledges the benefit of new data processing and communications techniques, and argued, consistent with the Commission's views, that the Terminals will provide investors with a cheaper and speedier means to route orders to the floor. IBI argued that the CBOE's market making restriction imposes restrictions that do not apply to other devices, and thereby would unfairly penalize IBI for its technological achievements. Finally, IBI argued that the provision provides no regulatory benefit, merely serving to protect market makers from competition. IBI claimed that the CBOE's concern that without the prohibition market makers will withdraw from its floor is not true. IBI noted that other benefits accrue to being on the floor, and believes that by increasing volume, the Terminals could encourage market maker floor participation, rather than discourage it.

B. CBOE Response Letter

The CBOE Response Letter to the November 1995 Comment Letter stated that IBI misread Paragraph C to prohibit two-sided limit orders. Rather, the provision is meant to restrict the acceptance of orders placed in the performance of a market making function. According to the CBOE, this would require an aggregate pattern of orders from an investor indicating the performance of a market making function, not merely the entry from time to time of two-sided limit orders. Therefore, the CBOE believes that Paragraph C is not overly broad because it would permit two-sided limit orders occasionally to be entered by the same customer and would not, as IBI suggests, restrict different investors from inputting orders on opposite sides of the market.

In response to IBI's concerns about the enforcement of the restriction by floor brokers, the CBOE argued that it is the member's responsibility to ensure compliance with the market making restriction. In support of this, the CBOE noted that the Application Agreement is between the Exchange and a member organization doing business with the public, and, in addition, Paragraph F of the Application Agreement would require a member to maintain an adequate audit trail of transactions and customer activities, ensuring the ability of the Exchange to enforce Paragraph C. In support of its argument, the CBOE cited various rules which require members to know their customers and what their customers are doing with respect to their transactions on the CBOE. The Exchange noted that compliance with the market making restriction lies with the member firm and not the floor broker.

The CBOE further argued that Paragraph C does not discriminate between customers as IBI alleges because the restriction applies equally to all customers. According to the CBOE, the reason a market making prohibition does not exist for other CBOE order delivery systems is that it would be impractical for customers to use such systems to perform market making functions. The CBOE argued that allowing investors to use terminals to perform off-floor market making functions in SPX options would grant them all the advantages enjoyed by a market maker without imposing any of the concomitant obligations, thereby compromising the viability of CBOE's markets. The CBOE also noted that the off-floor market maker would receive other benefits not available to CBOE market makers.[11] In this context, the CBOE notes that if a market maker had the freedom to leave the floor and perform market making through a Terminal, many would do so to avoid the obligations of being a market maker. The CBOE believes this would compromise the continued viability of its markets.

The CBOE also disputed the ''burden on competition'' and ''price discovery'' arguments by repeating that the provision does not bar all two-sided limit orders, just the entry of such orders that constitute market making. The CBOE also argued that to the extent the market making prohibition could be deemed a burden on competition, it is necessary and appropriate in furtherance of the Act, including Sections 6(b)(5) and 11A of the Act, given the CBOE's expressed concern that, absent the prohibition, the introduction of Terminals would cause CBOE market makers to leave the floor.

C. February 1996 Comment Letter

In its February 1996 Comment Letter, IBI disputed the CBOE Response Letter's contention that to allow Terminals to be used to perform market making functions could compromise the quality and viability of the CBOE's markets. First, IBI claimed that CBOE market makers enjoy many benefits and few burdens. In doing so, IBI referred to CBOE Rule 8.7, Interpretation .03B., which states that only 25% of a market maker's trades need be executed in person in a given calendar quarter.[12] Second, IBI claimed that there is no evidence that market makers would leave the CBOE floor if IBI's position were to prevail. Finally, IBI argued that if the public benefits from market participants' willingness to make continuous two-sided markets, then there is no reason to restrict those investors who have no obligation to make two-sided markets from making regular or continuous two-sided markets. IBI concluded that for these reasons, Paragraph C does not represent a proper exercise of the CBOE's rulemaking authority under the Act. Rather, IBI argued that the market

[11] For example, an off-floor market maker would be entitled to the firm quote accorded customers under CBOE Rule 8.51, Retail Automatic Execution System executions, participate in cross transactions under Rule 6.74(b), and enter its orders in the limit order book under CBOE Rule 7.4.

[12] The Commission notes, however, that for a market maker to receive market maker treatment for off-floor orders, the market maker must execute at least 80% of its transactions in person. CBOE Rule 8.7, Interpretation .03B. Moreover, at least 75% of a market maker's total contract volume must be in option classes to which it has been appointed. CBOE Rule 8.7, Interpretation .03A.

making restriction contravenes the policies of the Act favoring competition among market participants, investor protection, and the introduction of new communication technologies.

D. November 1996 Letter

The November 1996 Letter withdrew without prejudice IBI's objection to the proposed rule change, in order to permit floor brokers to begin using terminals to represent customer orders in accordance with the CBOE's proposal. In withdrawing its opposition, IBI stated that it is in the best interest of its customers in the short run to permit use of the Terminals quickly. The November 1996 Letter also requested that the Commission interpret the term ''market making function'' used in Paragraph C in a manner that could not be used to restrict unduly market access and broad competition. The November 1996 Letter asked the Commission to provide specific examples of permitted conduct in an approval order of the proposed rule change, such that market participants would be able to provide more efficient pricing.

The November 1996 Letter expressed concern that a Commission order recognize that there is less depth and liquidity prevailing in certain equity options and industry index products than in the SPX. IBI requested that the Commission recognize the role of two-sided limit orders in narrowing spreads and providing liquidity in markets that are not as deep and liquid as the SPX.[13]

IV. Discussion

A. General

Section 6(b)(5) of the Act[14] requires that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principals of trade, remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest. Section 6(b)(7) of the Act[15] requires that the rules of an Exchange be in accordance with Section 6(d) of the Act,[16] and in general provide a fair procedure for the disciplining of members and the prohibition or limitation by an exchange of a person's access to services offered by the exchange. Section 6(b)(8) of the Act[17] requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Section 11A(a)(1)(C)(ii) of the Act[18] states that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure fair competition among brokers and dealers. For the reasons set forth below, 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 Sections 6(b)(5), 6(b)(7), 6(b)(8), and 11A(a)(1)(C) of the Act.

The Commission believes that the CBOE's proposal should foster coordination with persons engaged in facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market, and protect investors and the public interest by expediting and making more efficient the process by which members can receive and execute SPX orders on the floor of the Exchange. The proposal also will promote fair competition among brokers and dealers and facilitate transactions in options on the Exchange. The Commission also believes that the requirement that an applicant file the Application Agreement with the Exchange and comply with it is reasonable and ensures adequate surveillance and compliance with CBOE Rules. Finally, for the reasons described in more detail below, the Commission believes that the market making prohibition on the use of the Terminals adequately balances the potential benefits to the derived from Terminals with the important regulatory issues that are raised in connection with the potential use of Terminals for market making in SPX options.

B. Application Agreement

Paragraphs H and K of the Application Agreement address the physical, electrical and communication issues presented by the introduction of Terminals. These provisions should allow the Exchange to take into consideration the needs of all members in the allocation of limited space and communication resources to ensure that Terminals do not interfere with one another or with other Exchange systems.

Paragraph E of the Application Agreement generally will prohibit a member or associated person from trading with orders transmitted through a Terminal, unless no other member were to trade with the order, or the applicant were to trade on the same basis as other members who do not have priority. In addition, Paragraph E will prohibit a member from using for its benefit information transmitted through a Terminal before that information is disclosed to the trading crowd.[19] The Commission believes that these restrictions are appropriate given the two concerns the Exchange asserted Paragraph E is designed to address. First, that the applicant or one of its associated persons might interact with an order—in effect internalizing it—prior to information relating to such order becoming known to the trading crowd, which would be inconsistent with the open auction market principles governing the Exchange's trading system. Second, the knowledge of order information in the system could give the applicant or an associated person the ability to effect transactions or to change quotes in the Exchange's market or in the markets for the underlying interest or related interests before the information were available in the market. The Commission also believes that the two exceptions to the general restriction on trading with orders in the Terminal system are consistent with these concerns, and ensure that members using Terminals trade on the same terms and conditions as other market participants and do not receive any trading advantages to interact with orders transmitted through the Terminals.

Paragraphs D and F of the Applicant Agreement relate to surveillance, audit trails, and compliance. The Commission believes that these provisions should serve to ensure that an applicant clearly understands its obligation to adhere to the applicable laws, rules, policies, and procedures of the Application Agreement, Exchange, and Commission. The Exchange will oversee that obligation through inspection and audit.

[13] The Commission recognizes that markets for certain equity options can be less deep and liquid than the SPX market. However, the rule change approved today concerns the use of Terminals only in the SPX crowd. The Commission will consider the merits of permitting the use of Terminals to represent two-sided limit orders that effectively create regular two-sided markets in less liquid options crowds when it is presented with that issue.

[14] 15 U.S.C. § 78f(b)(5) (1988).

[15] 15 U.S.C. § 78f(b)(7) (1988).

[16] 15 U.S.C. § 78f(d) (1988). Section 6(d) of the Act, among other things, requires that an exchange, in any proceeding to determine whether a member should be disciplined, bring specific charges, notify such member of and provide him with an opportunity to defend himself against such charges, and keep a record.

[17] 15 U.S.C. § 78f(b)(8) (1988).

[18] 15 U.S.C. § 78k–1(a)(1)(C) (1988).

[19] The Exchange believes that it would be inconsistent with just and equitable principles of trade for a member or its associated persons to use, or to permit the use of, information in a customer's order prior to the disclosure of that information to the market, except if such use is in accordance with the instructions of the customer and is consistent with Exchange rules. Amendment No. 1, *supra* note 3.

The Application Agreement explicitly limits the use of a Terminal to the SPX options trading crowd. The Commission believes that it is consistent with the Act for the Exchange to limit the introduction of Terminals at this time given the Exchange's stated desire to gain experience in their use and address any problems which may arise. The Commission notes that any decision to expand the use of Terminals beyond the SPX options trading crowd would require that the CBOE submit a proposed rule change to the Commission pursuant to Section 19(b) of the Act.

Paragraph L of the Application Agreement provides for the termination of the Exchange's approval of a member's Terminal under certain circumstances. As noted above, Paragraph L allows the Exchange, with 30 days notice, to terminate all approvals for Terminals in trading crowds on the CBOE floor or at particular posts. In addition, the Exchange summarily could terminate its approval of a member's Terminal use following a determination by the Office of the Chairman of the Exchange that the Exchange has given a member notice that a statement in that member's Application Agreement is inaccurate or incomplete, the member has failed to comply with any provision of the Application Agreement, or the Terminal is causing operational difficulties on the floor of the Exchange, and that member has failed to cure the same within seven calendar days following the giving of such notice. The Commission believes that the Paragraph L termination procedures are consistent with the Act, including Sections 6(b)(7) and 6(d) of the Act,[20] and are designed to provide affected members with adequate due process. The Commission notes that a member so affected could seek relief pursuant to the Hearings and Review provisions of Chapter XIX of the Exchange's Rules. These provisions provide specific procedures to seek Exchange hearing and review for persons aggrieved by action of the Exchange in terminating or enforcing the terms of the Application Agreement.[21]

C. Market Making Restriction

Paragraph C of the Application Agreement will allow a Terminal to be used to receive brokerage orders only, and not to perform a market making function. Orders that will be deemed to ''perform a market making function'' are those that create a pattern of offering in the aggregate either to make two-sided markets or simultaneously to represent opposite sides of the market in any class of options.

Although IBI has withdrawn its objections to Paragraph C of the Application Agreement,[22] for the reasons set forth below, the Commission believes that the November 1995 Comment Letter and the February 1996 Comment Letter raise some valid concerns about the CBOE proposal. For the reasons set forth below, the Commission finds that these objections have been adequately addressed and finds that the market maker restriction is consistent with the Act. Specifically, the Commission believes that Paragraph C currently represents an acceptable balancing by the Exchange of the potential benefits to be derived from Terminals against the CBOE's stated concern that to allow unrestricted off-floor market making could undermine the CBOE market maker system and could create disincentives for CBOE market makers to remain on the floor of the Exchange. The CBOE expressed concern that such off-floor market making effectively would establish a market making structure devoid of affirmative market making obligations. This could result in less deep and liquid markets, particularly during periods of market stress, when Terminal users engaged in unrestricted off-floor market making would be under no obligation to continue making markets. The Commission believes these concerns are reasonable, and disagrees with IBI's contention that Paragraph C represents an unacceptable exercise of the Exchange's rulemaking authority. Similarly, the Commission disagrees with IBI that the CBOE is attempting to limit the introduction of new technology. The CBOE's proposal will allow the introduction of an innovative technology into one of its most active trading crowds, while doing so in a manner designed to ensure the continued viability of its market maker system.

IBI claimed that CBOE market makers enjoy many benefits, but few burdens. The Commission notes, however, that while market makers derive certain benefits in connection with their market making functions, the obligations they assume are substantial. For example, CBOE Rule 8.7 requires generally that a market maker's transactions constitute a course of dealing reasonably calculated to contribute to the maintenance of a fair and orderly market. Specific requirements include a market maker's continuous obligation to deal for his or her own account when there is a lack of price continuity, or when there is a disparity between supply and demand for a particular option contract, or between option contracts of the same class. In fulfilling these requirements, a market maker must, among other things, compete with other market makers to improve markets, make markets, and update market quotations in response to changed market conditions. Moreover, market makers are specifically required to establish firm quotes with regard to public customer transactions, must meet specific trading requirements within their assigned options classes, and generally participate in Exchange sponsored automated trading systems. Although it is true as IBI states that only 25% of a market maker's trades must be executed in person, in actuality a much greater percentage of its transactions must be in person to be able to avail itself of the full benefits of market maker status.[23] In contrast, a customer using a Terminal to make markets would be entitled to benefits denied CBOE market makers.[24] Consequently, the Commission does not agree with IBI's contention that CBOE market makers' obligations are illusory. Rather, it is legitimate for the CBOE to be concerned about significant unfair competition if IBI customers were allowed to make markets whenever they so chose while still receiving the benefits of being a public customer under CBOE rules.

IBI maintained that a non-market maker should be able to make two-sided markets on a continuous or regular basis even though he has no obligation to do so because it would benefit the public. The Commission believes, however, that any purported benefit to be derived from such off-floor market making could be more than off-set by the potential harm identified by the CBOE regarding such activity. Notably, Terminal users acting as market makers by making, in the aggregate, a pattern of two-sided markets would not be subject to CBOE requirements to make continuous markets, nor to direct CBOE surveillance and monitoring. Because off-floor market makers potentially would enjoy the benefits of other ''public customers,'' while not having the concomitant obligations and responsibilities of CBOE market makers, the Commission does not believe it is unreasonable for the CBOE to determine that the introduction of unregulated

[20] *See supra* notes 15–16, and accompanying text.

[21] *See* CBOE Rules 19.4, Hearing, and 19.5, Review.

[22] November 1995 Comment Letter and February 1996 Comment Letter, *supra* note 5; and *supra* Parts III.A. and C.

[23] *See supra* note 12.

[24] *See supra* note 11.

market making through Terminals could undermine its market maker system.

The Commission also believes that the CBOE restriction on market making through the use of Terminals has been effected in a clear and reasonable manner that is not ambiguous nor overboard, and that takes into account regulatory and market impact concerns, including those relating to quote competition and price discovery.[25] Notably, the CBOE's proposal does not bar all two-sided limit orders. Instead it only restricts the acceptance of orders placed in the performance of a market making function. The distinction between market making and brokerage activity is well established among market participants. Moreover, the language of Paragraph C expressly restricts only an aggregate pattern of orders from an investor which indicates whether an investor is performing a market making function, not the occasional entry of two-sided limit orders. Thus, the restriction on Terminal use for routing limit orders is the minimum necessary for the CBOE to bar Terminal use for off-floor market making.

By approving this proposed rule change, the Commission is not stating that it is impermissible for an options exchange to permit users of Terminals or other similar devices to make two-sided markets. Indeed, the CBOE may determine to reconsider its decision not to permit users to Terminals to engage in market making at some future time. Nevertheless, while it is not illegal to permit off-floor market making, the Commission believes that it is within the CBOE's prerogative as a exchange to prohibit it. The Commission notes that the CBOE is particularly concerned that off-floor market making effectively would establish a market making structure devoid of affirmative market making obligations that could result in less deep and liquid markets during periods of market stress, when off-floor Terminal market makers would not be required to continue making markets. The Commission believes that these concerns are reasonable. Moreover, as noted above, surveillance of market making through the Terminals currently would be particularly difficult. The Commission's approval of the CBOE rule change reflects the Commission's belief that the CBOE may act incrementally in approving the use of Terminals for transactions in SPX options given that the CBOE does not know the possible impact of Terminals upon its market.

The Commission also emphasizes that it expects the CBOE to interpret the term ''market making'' in accordance with its traditional definition as defined under the Act, *i.e.*, holding one's self out as being willing to buy *and* sell a particular security on a regular or continuous basis.[26] The definition of market making should not capture parties who enter orders on one side of the market; nor would it capture parties who enter two-sided limit orders on occasion. A party would not be deemed to be engaging in market making unless it regularly or continuously holds itself out as willing to buy and sell the security.[27]

For the same reasons described below, the Commission does not believe that the CBOE's proposal imposes a burden on competition or restraint on technology not necessary or appropriate under the Act. As noted above, regulatory and compliance issues are raised by off-floor market making through the Terminals. The CBOE's restriction also serves to ensure fair competition among persons making markets on the CBOE consistent with Section 11A of the Act. Accordingly, the Commission believes that any burden on competition that arguably exists by the restriction on Terminal use is justified as reasonable and appropriate to ensure adequate regulation of the CBOE's markets.

IBI also has claimed that the CBOE's rule change unfairly discriminates between Terminal users and customers using other means such as telephones to transmit orders. The Commission, however, agrees with the CBOE that, unlike the use of Terminals, other means of transmitting orders do not allow a customer effectively to engage in market making. As the CBOE notes, other systems on its floor ''do not have the technical capability to permit an investor to make and change, with adequate speed, the wide range of quotes necessary to perform a market making function effectively.'' The CBOE's proposal, therefore, does not discriminate between customers using different methods of transmitting orders, but rather serves to delineate the distinction between market makers and customers. In summary, the prohibition does not unfairly discriminate because it applies equally to all investors using a Terminal, which, unlike other available technologies, have the capability to allow market making functions.

Finally, the Commission disagrees with IBI's contention that the CBOE's proposal places a burden on floor brokers by requiring them to determine whether customers are engaged in market making. As noted by the CBOE, the Application Agreement would be between the Exchange and a member organization doing business with the public. Under the terms of the Application Agreement, a member would be required to maintain an audit trail sufficient to determine adherence to Paragraph C of the Application Agreement. Thus, floor brokers would not be required to monitor such adherence, and compliance would be within the member's responsibilities. In any event, as noted above, the Commission believes the CBOE's market making restriction is clear enough to provide guidance to monitor trading activity for compliance with the restriction.

In summary, while the CBOE's restrictions on the use of Terminals raise regulatory issues, the Commission believes that, within the context of the SPX options trading crowd, the market making restriction is an acceptable exercise of the Exchange's rulemaking authority. While the Commission recognizes that there may be different ways to address the regulatory issues presented by off-floor market making through the use of Terminals, the Act does not dictate that any particular approach be taken. The Commission believes that the manner in which the Exchange has chosen to address the regulatory issues presented by off-floor market making reflects the considered judgement of the CBOE regarding the attributes of Exchange membership and the organization of its trading floor, and is a fair exercise of its powers as a national securities exchange.

V. Conclusion

In view of the above, the Commission finds that the proposal is reasonable and is consistent with the Act, and, in particular, Sections 6(b)(5), 6(b)(7), 6(b)(8), and 11A(a)(1)(C)(ii) of the Act.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[28] that the

[25] *Cf.*, Securities Exchange Act Release No. 25842 (June 23, 1988), 53 FR 24359 (approving certain restrictions on the use of telephones on the floor of the New York Stock Exchange), *aff'd per curiam*, 866 F.2d 47 (2d Cir. 1989).

[26] *See e.g.*, 15 U.S.C. § 78c(a)(38); Securities Exchange Act Release No. 36719A (Sept. 6, 1996), 61 FR 48290, 48316 (Sept. 12, 1996).

[27] Securities Exchange Act Release No. 36719A (Sept. 6, 1996), 61 FR 48290, 48316 (Sept. 12, 1996). The Commission notes that a broker using a Terminal may receive numerous orders from multiple customers, some of which are on the bid side and others on the offer side of an SPX series. This is consistent with a brokerage function, not a market making function. If, however, a particular customer of a broker regularly or continuously places two-sided limit orders, then the CBOE might, under certain circumstances, reach a different conclusion as to the nature of the function being performed by the broker and the customer.

[28] 15 U.S.C. § 78s(b)(2) (1988).

proposed rule change (File No. SR–CBOE–95–48) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[29]

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34–38048; File No. SR–GSCC–96–13]

Self-Regulatory Organizations; Government Securities Clearing Corporation; Notice of Filing of a Proposed Rule Relating to the Eligibility of Treasury Inflation Protection Securities for Netting Services

December 13, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on November 21, 1996, the Government Securities Clearing Corporation (''GSCC'') 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 primarily by GSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The proposed rule change will make the U.S. Department of Treasury's Treasury Inflation Protection Security eligible for clearance and settlement at GSCC.

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

In its filing with the Commission, GSCC 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. GSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.[2]

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

The purpose of the proposed rule change is to make the Treasury Inflation Protection Security eligible for clearance and settlement at GSCC. The Treasury Inflation Protection Security is a marketable, book-entry inflation protection security that is being issued by the Department of the Treasury,[3] GSCC believes that in order to maximize the desirability of the Treasury Inflation Protection Security from a trading perspective and to ensure that their introduction does not result in any increased clearance and settlement risk for the marketplace, GSCC should be able to compare, net, and settle these securities. Therefore, GSCC is planning to make the Treasury Inflation Protection Security eligible for its netting process prior to the U.S. Department of Treasury's first auction of the Treasury Inflation Protection Security, which is scheduled for the January 1997 auction of the ten-year note. Other maturities will be issued later.

The Treasury Inflation Protection Security provides inflation protection by adjusting semiannually the principal amount of investors' holdings by multiplying the stated value at issuance (*i.e.,* par amount) by an index ratio. The applicable index will be the U.S. City Average All Items Consumer Price Index for All Urban Consumers (''CPI'') published by the Bureau of Labor Statistics of the U.S. Department of Labor. The Treasury Inflation Protection Security will be redeemed at maturity at the greater of its inflation adjusted principal or its par amount.

The Treasury Inflation Protection Security will be issued with a stated fixed rate of interest based on the rate determined at auction. Although the interest rate is fixed, because the interest rate is paid on a varying amount of principal, the coupon payments will also be variable. This will be the first time that GSCC has made a variable-rate security eligible for netting.

For GSCC to process the Treasury Inflation Protection Security, the following enhancements must be made to GSCC's automated system.

1. Creation and maintenance of a database of historical CPI indexes. This data is necessary for determining accrued interest, which is used in valuing positions for settlement purposes and for forward margin and clearing fund calculations.

2. Modification of the security database to permit GSCC to designate the Treasury Inflation Protection Security as a variable rate security.

3. Modifications to participant input and output formats to take into account different and additional data elements.

After these enhancements have been made, GSCC plans to test with GSCC members before ''going live'' with the new service in order to ensure that participants are able to properly provide and receive data regarding transactions in these new securities.

GSCC worked with the Public Securities Association to determine a uniformly acceptable method for the industry to reflect the inflation index in the calculation of final money on Treasury Inflation Protection Security transactions. Consistent with these discussions, participants will submit transactions using a price that has not been adjusted for inflation. GSCC will compare and report transactions based on its Final Settlement Money formula. Final Settlement Money will equal the original par value multiplied by the CPI index ratio multiplied by the unadjusted price plus the inflation adjusted accrued interest. Inflation adjusted accrued interest will equal the original par value multiplied by the inflation ratio multiplied by the CPI index ratio multiplied by the interest rate multiplied by the term.

GSCC believes that the proposed rule change is consistent with the requirements of Section 17A(b)(3)(F) of the Act[4] and the rules and regulations thereunder because it is designed to promote the prompt and accurate clearance and settlement of securities transactions.

(B) Self-Regulatory Organization's Statement of Burden on Competition

GSCC does not believe that the proposed rule change will have an impact or impose a burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments relating to the proposed rule change have not yet been solicited or received. Members will be notified of the rule change filing, and comments will be solicited by an important notice. GSCC will notify the

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[29] 17 CFR 200.30–3(a)(12) (1994).

[1] 15 U.S.C. 789s(b)(1).

[2] The Commission has modified the text of the summaries prepared by GSCC.

[3] The Department of Treasury has proposed amendments to 31 CFR Part 356 (Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds) to accommodate the issuance of the Treasury Inflation Protection Security. Department of Treasury Circular, Public Debt Service No. 1–93 (September 23, 1966), 61 FR 50924 (September 27, 1996).

[4] 15 U.S.C. 78q-1(b) (3) (F).