

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44339; File No. SR-CBOE-2001-16]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Incorporated Relating to the Proposed Order "PACER"

May 22, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 2, 2001, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. On April 20, 2001, the CBOE submitted to the Commission Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The CBOE proposes to amend its rules to add a new parameter, the order PACER, to its Order Routing System ("ORS"). PACER will enable the CBOE to modulate the frequency of executions through the Exchange's Retail Automatic Execution System ("RAES"). Below is the text of the proposed rule change, as amended by Amendment No. 1. Proposed new language is italicized.

#### Rule 6.8: RAES Operations

(d)(vi)

*The appropriate Floor Procedure Committee ("FPC") may regulate the frequency of executions through RAES. To regulate the frequency, the FPC may institute a "PACER interval" applicable to a member firm's RAES orders on the same side of the market within a given class of options. The PACER interval, which shall be activated by an initial RAES execution, shall prohibit subsequent RAES executions by the same*

*member firm on the same side of the market within the same class until a set amount of time (the PACER interval) expires. Upon expiration of the PACER interval, that member firm would again be entitled to receive RAES executions in that class, subject to subsequent PACER restrictions. The appropriate FPC shall determine the length of the PACER interval. RAES-eligible orders received during the PACER interval shall be routed to PAR. The PACER interval shall not be applicable to orders that execute against EBOOK.*

*When there is a large influx of orders that route from RAES that are rerouted for manual handling such that there are more orders than can be handled expeditiously, the DPM for the class, with input from the trading crowd, shall have the ability to disengage the order PACER for that class. When the influx of orders subsides such that orders may be handled expeditiously, the DPM in the affected class, upon receipt of approval by two Floor Officials, may reactivate PACER in the affected class.*

*For purposes of this rule, long (short) calls and short (long) puts shall be considered to be on the same side of the market.*

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

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

##### 1. Purpose

The Exchange proposes to amend CBOE Rule 6.8(d) to enable the appropriate Floor Procedure Committee ("FPC") to limit the frequency with which member firms can receive executions through RAES. Under the proposal, CBOE will add a new parameter, the order PACER, that will enable it to modulate the frequency of executions through RAES. The CBOE represents that the proposal is designed to permit customers to continue to receive the benefits of automatic execution of their small option orders while at the same time allowing market makers to limit their exposure to artificial depth.

When PACER is engaged, individual member firms will be entitled to execute, in a particular class, one RAES order (regardless of series) on the same

side of the market every designated number of seconds. The appropriate FPC shall determine and establish the length of time for the PACER interval setting on a class-by-class basis.<sup>4</sup> If the PACER interval is established at five seconds, each individual member firm would be entitled to receive one execution through RAES for all orders in all series within the same class on the same side of the market per five-second interval. For purposes of this proposal, the following orders shall be deemed to be on the same side of the market:

- Long calls and short puts (bullish side of the class)
- Short calls and long puts (bearish side of the class)

For example, if Firm XYZ executes an order through RAES to buy 50 calls for a particular option, it would be ineligible to receive additional RAES executions for either long calls or short puts in any series of that option class until the PACER interval period expired. Firm XYZ orders on the opposite side of the market (*i.e.*, short calls and long puts) would be eligible for execution, subject to the PACER parameters applicable to the opposite side of the market (*i.e.*, one order execution every x seconds). Firms XYZ's RAES-eligible orders sent through ORS that are received during the period the PACER interval precludes automatic execution (*i.e.*, before x seconds expire) would not be routed to RAES and instead would be sent to PAR where they would be handled in accordance with applicable procedures.

The PACER interval will apply only to RAES orders that would be assigned to market makers via standard RAES allocation methods (*e.g.*, the Wheel or Variable RAES). As such, the PACER interval would not apply to RAES orders executed against EBOOK via ABP or ABP Split-Price.<sup>5</sup> As an example, if

<sup>4</sup> While the appropriate FPC shall establish the length of the PACER interval, the Designated Primary Market Maker ("DPM") for a particular class, with input from the trading crowd, shall have the ability to disengage and reactivate the order PACER for that class under the circumstances set forth in Amendment No. 1. These circumstances are discussed below.

<sup>5</sup> ABP is an acronym for the Exchange's Automated Book Priority system. ABP enables a RAES order to execute against the book when the book represents the best price on the Exchange. See Securities Exchange Act Release No. 41995 (October 8, 1999), 64 FR 56547 (October 20, 1999) (SR-CBOE-99-29). Under ABP Split Price, if an incoming RAES order is larger than a booked order that is establishing the Exchange's best price, the RAES order will be executed against the booked order. Formerly, the remainder of that RAES order would be executed in its entirety at the book price against market-makers participating on RAES. Under ABP Split Price, the RAES order is only executed at the booked price up to a pre-set "Book

Continued

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

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

<sup>3</sup> In Amendment No. 1, the CBOE described the circumstances in which a Designated Primary Market Maker ("DPM") may disengage and reactivate PACER. In addition, Amendment No. 1 also made technical corrections to the language of the proposed rule change. See letter from Stephen M. Youhn, Attorney, CBOE, to Gordon Fuller, Counsel to the Assistant Director, Division of Market Regulation, SEC, dated April 19, 2001. Amendment No. 1 is discussed in more detail in Section II.A. below.

the EBOOK represents the best price for a series along with Autoquote and ORS receives three RAES-eligible orders to buy the same series (submitted by the same member firm), the first order would be executed against the EBOOK (extinguishing the order on the book). The second order would be executed in RAES, activating the PACER interval timer. The third order, because it was received during the period the PACER interval was activated, would not receive automatic execution and instead would be routed to the PAR station.

In Amendment No. 1, the CBOE revised the language of proposed Rule 6.8(d)(vi) to clarify the circumstances in which the DPM for a particular class may disengage and reactivate PACER for that class. The Amendment states that the DPM may disengage PACER for a particular class, with input from the trading crowd, "[w]hen there is a large influx of orders that route from RAES that are rerouted for manual handling such that there are more orders than can be handled expeditiously \* \* \*."<sup>6</sup> When the influx of orders subsides such that orders may again be handled expeditiously, the DPM in the affected class may activate PACER for that class upon receipt of approval by two Floor officials. In this connection, the CBOE represents that it will comply in all respects with CBOE Rule 6.8.08.<sup>7</sup> Specifically, the CBOE states that it will document all instances in which PACER is disengaged in a class and subsequently reengaged during the same trading day, the reasons for such action, and the identity of the Floor Officials involved in the decision to reengage PACER.<sup>8</sup>

In addition, in Amendment No. 1 the CBOE represented that it expects that PACER will be activated floor-wide in all classes under normal market conditions. The CBOE stated that, while the Equity FPC ("EFPC") retains the

authority to establish the length of the PACER interval, the EFPC normally meets only once every two weeks. This will preclude it from determining to alter the length of the PACER interval on an intraday basis. The CBOE stated that, as indicated in the original filing, the EFPC has the authority to deactivate PACER for a particular class or to establish the length of the PACER interval on a class-by-class basis. The CBOE represented that it will post on its public website the length of the PACER interval applicable to all affected classes.

## 2. Statutory Basis

The Exchange believes the proposal represents an efficient mechanism whereby customers can continue to receive the benefits of automatic execution of their small option orders while at the same time allowing market makers to limit their exposure to artificial depth. For these reasons, the Exchange believes the proposal is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of section 6(b) of the Act. Specifically, the Exchange believes the proposed rule change is consistent with the requirements under section 6(b)(5)<sup>9</sup> that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, and, in general, to protect investors and the public interest. Furthermore, the Exchange believes that the proposed rule change is consistent with the Act's requirement that an exchange's rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

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

The CBOE does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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

No written comments were solicited or received with respect to the proposed rule change.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE.

All submissions should refer to File No. SR-CBOE-2001-16 and should be submitted by June 20, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

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

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Price Commitment Quantity" set by the FPC. Thereafter, if any part of the RAES order is still unfilled, the remainder will be executed at the next prevailing bid or offer, i.e., the book price or the Autoquote price. If the Autoquote system is not in effect, the remainder of the RAES order would be routed to the crowd PAR terminal for manual execution, whether against the book or competing members of the trading crowd. See Securities Exchange Act Release No. 43932 (February 6, 2001), 66 FR 10332 (February 14, 2001) (SR-CBOE-00-21).

<sup>6</sup> Amendment No. 1, *supra* note 3.

<sup>7</sup> CBOE Rule 6.8.08 states that "[t]he Exchange will document in its Control Room log, or in any other format provided for by the Exchange, any action taken to disengage RAES or to operate RAES in a manner other than normal, the option classes affected by such action, the time such action was taken, the Exchange officials who undertook such action, and the reasons why such action was taken."

<sup>8</sup> See Amendment No. 1, *supra* note 3.

<sup>9</sup> 15 U.S.C. 78(f)(b)(5).

<sup>10</sup> 17 CFR 200.30-3(a)(12).