

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39879; File No. SR-CBOE-98-03]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to Allocation Procedures

April 16, 1998.

I. Introduction

On January 22, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4² thereunder, a proposed rule change to codify the Exchange's process for allocating securities to market-maker trading crowds and designated primary market-makers ("DPMs").

The proposed rule change, as modified by amendments,³ was published for comment in the **Federal Register** on March 12, 1998.⁴ No comments were received on the proposal. This order approves the proposed rule change, as amended.

II. Description

The Exchange's Board of Directors has delegated to the Exchange's Allocation Committee and Special Product Assignment Committee the authority to allocate the securities traded on the Exchange. Each security traded on the Exchange is allocated either to a market-maker trading crowd or to a DPM.⁵ To codify the process the Exchange uses to make those allocations, the CBOE

proposes to adopt new CBOE Rule 8.95, "Allocation of Securities and Location of Trading Crowds and DPMs." CBOE Rule 8.95 will consist of seven subparagraphs, (a) through (g), and contain two interpretations.

Proposed CBOE Rule 8.95(a) provides that the Allocation Committee shall be responsible for determining for each equity option class traded on the Exchange (i) whether the option class should be allocated to a trading crowd or to a DPM and (ii) to which trading crowd or DPM the option class should be allocated. Similarly, proposed CBOE Rule 8.95(a) provides that the Special Product Assignment Committee shall be responsible for determining for each security traded on the Exchange other than an equity option (i) whether the security should be allocated to a trading crowd or to a DPM and (ii) to which trading crowd or DPM the security should be allocated. Securities other than equity options that are traded on the Exchange include index options and securities traded pursuant to Chapter XXX, "Stocks, Warrants and Other Securities," of the Exchange's Rules, such as structured products.

Proposed CBOE Rule 8.95(a) further provides that the Allocation Committee shall be responsible for determining the location on the Exchange's trading floor of each trading crowd, each DPM, and each security traded on the Exchange. For example, this provision permits the Allocation Committee to place a large trading crowd or DPM operation in a trading floor location that is large enough to accommodate the crowd or DPM. As another example, if a DPM operate as a DPM at more than one trading station, this provision permits the Allocation Committee to determine the station, and the location within each station, at which the securities allocated to the DPM will trade.

Proposed CBOE Rule 8.95(b) describes the criteria that may be considered by the Allocation Committee and Special Product Assignment Committee in making security allocation determinations and by the Allocation Committee in making location determinations. The factors to be considered may include, but are not limited to, any one or more of the following: performance, volume, capacity, market performance commitments, operational factors, efficiency, competitiveness, environment in which the security will be traded, expressed preferences of issuers, and recommendations of other Exchange committees.

The following are some examples of the many ways in which these criteria may be applied. For example, in

considering performance, the appropriate Allocation Committee (*i.e.*, the Allocation Committee or Special Product Assignment Committee, as applicable) might look at the market performance ranking of the applicable trading crowds or DPMs, as established by market performance reviews that are conducted by the Exchange's Market Performance Committees and Modified Trading System ("MTS") Appointments Committee.⁶ In considering volume, the appropriate Allocation Committee might look at the anticipated trading volume of the security and the trading volume attributable to the applicable trading crowds or DPMs in determining which trading crowds or DPMs would be best able to handle the additional volume. Similarly, in considering capacity, operational factors, and efficiency, the appropriate Allocation Committee might look to criteria such as the number of market-makers or DPM personnel, the ability to process order flow, and the amount of trading crowd or DPM capital in determining which trading crowds or DPMs would be best able to handle additional securities. In considering market performance commitments, the appropriate Allocation Committee might look at the pledges a trading crowd or DPM has made with respect to how narrow its bid-ask spreads will be and the number of contracts for which it will honor its disseminated market quotations beyond what is required by the Exchange's Rules. In considering competitiveness, the appropriate Allocation Committee might look at percentage of volume attributable to a trading crowd or DPM in allocated securities that are traded on more than one exchange. In considering the environment in which the security will be traded, the appropriate Allocation Committee might seek a proportionate distribution of securities between the market-maker system and the DPM system and across individual trading crowds and DPMs. Also, in considering expressed preferences of issuers, the appropriate Allocation Committee might give consideration to the views of the issuer of a security traded pursuant to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On January 23, 1998, the CBOE filed a technical amendment to the filing, clarifying that the Exchange's Board of Directors had approved the proposed rule change in February 1997 (Amendment No. 1).

On February 12, 1998, the CBOE filed Amendment No. 2 to the proposal. Amendment No. 2 deletes CBOE Rules 8.80(a) and 8.80(b)(7) and inserts an inadvertently omitted part of the Federal Register notice. See Letter from Arthur Reinstein, Assistant General Counsel, CBOE, to Joshua Kans, Attorney, Division of Market Regulation ("Division"), Commission, dated February 12, 1998 (Amendment No. 2).

On March 4, 1998, the CBOE filed Amendment No. 3 to the proposal. Amendment No. 3 clarifies the basis for deleting CBOE Rule 8.80(b)(7). Amendment No. 3 also notes that the CBOE is in the process of comprehensively amending CBOE Rule 8.80. See Letter from Arthur Reinstein, CBOE, to Joshua Kans, Division, Commission, dated March 4, 1998 (Amendment No. 3).

⁴ Securities Exchange Act Release No. 39725 (March 5, 1998), 63 FR 12119.

⁵ As part of this rule change, the Exchange is deleting existing CBOE Rules 8.80(a) and 8.80(b)(7). See Amendment Nos. 2 and 3, *supra* note 3.

⁶ The Exchange has three committees that perform market performance functions, including the evaluation of market performance. The Exchange's Market Performance Committee performs market performance functions with respect to all trading crowds, market-makers (other than DPMs), and floor brokers that trade in securities other than DJX, NDX, OEX, and SPX index options; the Index Market Performance Committee performs market performance functions with respect to the trading crowds, market-makers (other than DPMs), and floor brokers that trade DJX, NDX, OEX, and SPX index options; and the MTS Appointments Committee performs market performance functions with respect to all DPMs.

Chapter XXX with respect to the allocation of that security or to the licenser of an index on which an index option is based with respect to the allocation of that index option. Similarly, the appropriate Allocation Committee might consider the recommendations of other Exchange committees, particularly those that evaluate trading crowd and DPM market performance.

Proposed CBOE Rule 8.95(c) provides that the appropriate Allocation Committee may remove an allocation and reallocate the applicable security during the first six months following its allocation to a trading crowd or DPM if the trading crowd or DPM fails to adhere to any market performance commitments made by the trading crowd or DPM in connection with receiving the allocation. The Allocation Committees typically request that trading crowds and DPMs make market performance commitments as part of their applications to receive allocations of particular securities. As described above, these commitments may relate to pledges to keep bid-ask spreads within a particular width or to make disseminated quotations firm for a designated number of contracts beyond what is required by Exchange Rules. Proposed CBOE Rule 8.95(c) permits the appropriate Allocation Committee to remove an allocation if these commitments are not met and gives trading crowds and DPMs incentive to abide by these commitments. Following the initial six month period after an allocation is made, all the responsibility for monitoring market performance with respect to that security is vested in the appropriate Market Performance Committee or MTS Appointments Committee, which continually evaluate trading crowd and DPM market performance, as applicable, and are authorized pursuant to CBOE Rule 8.60, CBOE Rule 8.80, and other Exchange rules to take remedial action for failure to satisfy minimum market performance standards.

Proposed CBOE Rule 8.95(c) also provides that the appropriate Allocation Committee may change an allocation determination or change a location determination, if it concludes that doing so is in the best interest of the Exchange based on operational factors or efficiency. For example, if, due to market conditions, the trading volume in a security greatly increased over a short time frame and the trading crowd or DPM allocated the security could not handle the order flow, it may become necessary for the appropriate Allocation Committee to reallocate the security to a trading crowd or DPM with the

capacity to do so. Similarly, if the trading volume at a trading crowd or DPM post greatly increased and the number of crowd members or DPM personnel grew along with the increase in volume, it may become necessary for the appropriate Allocation Committee to relocate the trading crowd of DPM to a larger trading post.⁷

Proposed CBOE Rule 8.95(d) provides that prior to taking any action to remove an allocation or to change a location, the appropriate Allocation Committee shall generally give the affected trading crowd or DPM prior notice of the contemplated action and an opportunity to be heard concerning the action. The only exception to this requirement would be in those unusual situations when expeditious action is required due to extreme market volatility or some other situation requiring emergency action. Specifically, except when expeditious action is required, proposed CBOE Rule 8.95(d) requires that prior to taking any action to remove an allocation or to change a location, the appropriate Allocation Committee shall notify the trading crowd or DPM involved of the reasons the committee is considering taking the contemplated action, and shall either convene or more informal meetings of the committee (or a committee panel) with the trading crowd or DPM to discuss the matter, or provide the trading crowd or DPM with the opportunity to submit a written statement to the committee concerning the matter. Due to the informal nature of the meetings provided for under proposed CBOE Rule 8.95(d) and to encourage constructive communication between the committee and the affected trading crowd or DPM at those meetings, ordinarily neither counsel for the committee nor counsel for the trading crowd or DPM shall be invited to attend these meetings and no verbatim record of the meetings shall be kept.

As with any decision made by the Allocation Committee and the Special Product Assignment Committee, any

person adversely affected by a decision made by the appropriate Allocation Committee to remove an allocation or change a location may appeal the decision to the Exchange's Appeals Committee under Chapter XIX, "Hearing and Review," of the Exchange's Rules. The appeal procedures in Chapter XIX provide for the right to a formal hearing concerning any such decision and for the right to be accompanied, represented, and advised by counsel at the stages of the proceeding. In addition, any decision of the Appeals Committee may be appealed to the Exchange's Board of Directors pursuant to CBOE Rule 19.5, "Review."

Proposed CBOE Rule 8.95(e) provides that the allocation of a security to a trading crowd or DPM and the location of a trading crowd or DPM on the Exchange's trading floor does not convey ownership rights in the allocation or in the order flow associated with the allocation or location. Proposed CBOE Rule 8.95(e) is intended to make clear the trading crowds and DPMs may not buy, sell, or otherwise transfer an allocation or location to another party, and that instead, it is the Exchange that has the sole authority to determine allocations and locations on the Exchange's trading floor. Notwithstanding proposed CBOE Rule 8.95(e), Exchange rules will continue to permit the transfer of DPM appointments pursuant to CBOE Rule 8.80(b)(3), which provides for the transfer of appointments with the approval of the MTS Appointments Committee.

Proposed CBOE Rule 8.95(f) is intended to reflect the current restrictions that are in place with respect to the allocation of securities to DPMs. Proposed CBOE Rule 8.95(f) reiterates the provision currently contained in CBOE Rule 8.80(a) that no option classes opened for trading prior to May 1, 1987, shall be allocated to a DPM, except to the extent authorized by a membership vote.⁸ In addition, proposed CBOE Rule 8.95(f) modifies the foregoing provision, which was approved pursuant to an Exchange membership vote taken in November 1989. Under this modification, if a trading crowd indicates that it no longer wishes to trade an option class opened for trading prior to May 1, 1987, the option class may be reallocated to another trading crowd or to a DPM giving priority to trading crowd applications over DPM applications,

⁷ Under the proposal, when CBOE Rule 8.95(c) becomes effective, the CBOE would delete existing CBOE Rule 8.80(b)(7).

CBOE Rule 8.80(b)(7)(i) states that the MTS Appointments Committee may discontinue the use of a DPM in an option class if the trading activity in that class exceeds a predetermined volume. That provision is not superfluous because the CBOE membership voted in December 1993 to advise the MTS Appointments Committee not to exercise that authority. See Amendment 2, *supra* note 3.

Existing CBOE Rule 8.80(b)(7)(ii) permits the MTS Appointments Committee to discontinue use of a DPM in an option class if it determines that trading would be better accommodated by using a market-maker system without a DPM. Proposed CBOE Rule 8.95(c) would give similar authority to the appropriate Allocation Committee. See Amendment Nos. 2 and 3, *supra* note 3.

⁸ Proposed CBOE Rule 8.95(f) supersedes CBOE Rule 8.80(a). Accordingly, the CBOE proposes to delete CBOE Rule 8.80(a). See Amendment No. 2, *supra* note 3.

provided that the trading crowd's commitment to market quality is competitive and that operational considerations are satisfied.

Proposed CBOE Rule 8.95(g) provides that in allocating and reallocating securities to trading crowds and DPMs, the appropriate Allocation Committee shall act in accordance with any limitation or restriction on the allocation of securities that is established pursuant to another Exchange rule. For example, the appropriate Market Performance Committee or the MTS Appointments Committee may take remedial action against a trading crowd or DPM pursuant to CBOE Rule 8.60, "Evaluation of Trading Crowd Performance," and CBOE Rule 8.80(b)(10) for failing to satisfy minimum market performance standards, and such action may involve a restriction related to the allocation of securities to that trading crowd or DPM. Similarly, the MTS Appointments Committee may restrict a DPM's ability to receive or retain allocations of securities pursuant to various provisions of CBOE Rule 8.80, "Modified Trading System," including as a condition of appointment as a DPM (CBOE Rule 8.80(b)(3)), due to failure to perform DPM functions (CBOE Rule 8.80(b)(4)(i)), or due to a material, financial, operational, or personnel change (CBOE Rule 8.80(b)(4)(ii)). Proposed CBOE Rule 8.95(g) is intended to clarify that the appropriate Allocation Committee must act in accordance with any such restrictions in making allocation and location determinations.

Proposed CBOE Rule 8.95, Interpretation .01 generally provides that it shall be the responsibility of the appropriate Allocation Committee to reallocate a security if it is removed from a trading crowd or DPM pursuant to another Exchange rule or if for some other reason the trading crowd or DPM to which the security has been allocated no longer retains the allocation. For example, as described above, CBOE Rules 8.60 and 8.80 authorize the Market Performance Committees and the MTS Appointments Committee to take remedial actions against trading crowds and DPMs in specified circumstances, including the removal of an allocation. Proposed CBOE Rule 8.95, Interpretation .01 is intended to clarify that if the appropriate Market Performance Committee or the MTS Appointments Committee removes an allocation pursuant to CBOE Rule 8.60 or CBOE Rule 8.80, it is the responsibility of the appropriate Allocation Committee (and not the committee that took the action to

remove the allocation) to reallocate the security pursuant to proposed CBOE Rule 8.95. The only exception to this provision is that the MTS Appointments Committee is authorized, pursuant to CBOE Rule 8.80(b)(6), to allocate to an interim DPM on a temporary basis a security that is removed from another DPM, until the appropriate Allocation Committee makes a final allocation of the security.

Finally, proposed CBOE Rule 8.95, Interpretation .02 provides that it shall be the responsibility of the Allocation Committee to relocate a trading crowd or DPM in the event that the trading crowd or DPM is required to be relocated pursuant to another Exchange rule. As has been discussed, CBOE Rule 8.60 and CBOE Rule 8.80(b)(10) permit the Market Performance Committees and the MTS Appointments Committee to take remedial actions against trading crowds and DPMs in specified circumstances, including requiring that a trading crowd or DPM be relocated. Like proposed Interpretation .01, proposed Interpretation .02 is intended to clarify that if the appropriate Market Performance Committee or the MTS Appointments Committee requires the relocation of a trading crowd or DPM pursuant to CBOE Rule 8.60 or CBOE Rule 8.80(b)(10), it is the responsibility of the Allocation Committee (and not the Committee that took the action to require the relocation) to relocate the trading crowd or DPM.

III. 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, with the requirements of Section 6(b) of the Act.⁹ Specifically, The Commission believes that the proposal is consistent with the Section 6(b)(5)¹⁰ requirements that the rules of an exchange be designed to remove impediments to and perfect the mechanism of a free and open market and to protect investors and the public interest. Moreover, the proposal is consistent with the requirement of section 6(b)(5) of the Act that the rules of an exchange not be designed to permit unfair discrimination between brokers or dealers or issuers.

The Commission believes that the proposed rule change is appropriate because it codifies the Exchange's procedures for allocating securities between trading crowds and DPMs and determining where those trading crowds

or DPMs should be located.¹¹ Moreover, the Commission believes that the proposed provisions should help to ensure that securities traded by the Exchange are allocated in an equitable and fair manner, giving all trading crowds and DPMs a fair opportunity to obtain allocations.

Specifically, the Commission believes that the CBOE's proposed Rule 8.95(a)—which provides that the Exchange's Allocation Committee and the Special Product Assignment Committee are responsible for allocating option classes among trading crowds and DPMs, and which provides that the Allocation Committee is responsible for determining the location on the Exchange floor of each trading crowd, DPM and security—sets forth a fair and reasonable method of apportioning the responsibility for allocating securities and assigning space on the Exchange floor.

The Commission further believes that the CBOE's proposed Rule 8.95(b), which describes the information that the Allocation Committee and Special Product Assignment Committee may consider when making determinations under Rule 8.95(a), will give those committees the flexibility to consider all appropriate factors while putting the Exchange membership on notice of several of the important factors that may be considered in making such a determination.

The Commission also believes that the CBOE's proposed Rule 8.95(c), regarding removing allocations made under proposed Rule 8.95(a), provide a reasonable means of ensuring that the Allocation Committee and the Special Product Assignment Committee retain the ability to take actions to promote fair and efficient trading of the securities at issue. This provision also appropriately allocates responsibility between those two committees and the appropriate Market Performance Committee of MTS Appointments Committee.

The Commission believes that the CBOE's proposed Rule 8.95(d), which provides that, unless expeditious action is required, the affected trading crowd or DPM will receive notice of a potential action under proposed Rule 8.95(c), and will have the opportunity to participate in an informal meeting with the appropriate committee or submit a written statement concerning the matter, provides a fair and reasonable means of making expeditious decisions regarding allocation and location while protecting the interest of the affected trading crowd

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ Teleconference between Arthur Reinstein, CBOE, Yvonne Fraticelli, Attorney, Commission and Joshua Kans, Commission, January 29, 1998.

or DPM. In making this determination, the Commission notes that any person adversely affected by a decision made under proposed Rule 8.95(c) has the right to a formal hearing, with the assistance of counsel, before the Exchange's Appeals Committee. Moreover, decisions of the Appeals Committee may be appealed to the Exchange's Board of Directors.

The Commission believes that the CBOE's proposed Rule 8.95(e)—which provides that the allocation of security to a trading crowd or a DPM, or the assignment of a trading crowd's or a DPM's location on the Exchange's floor, does not convey ownership rights in the allocation or location or associated order flow—merely reiterates the limited nature of those allocations, and highlights that the Exchange retains the authority to determine allocations and locations.

The Commission believes that the CBOE's proposed Rule 8.95(f), which provides special rules for option classes opened for trading prior to May 1, 1987, merely reflects existing practices that are consistent with the will of the Exchange's membership.

The Commission believes that the CBOE's proposed Rule 8.95(g), which states that in allocating and reallocating securities the Allocation Committee and the Special Products Assignment Committee shall act in accordance with restrictions and limitations established pursuant to other Exchange rules, ensures that proposed Rule 8.95 does not cause any inconsistencies with existing Exchange rules, and that other Exchange committees are not hindered in the exercise of their own responsibilities.

The Commission believes that the CBOE's proposed Rule 8.95, Interpretation .01, which provides that the Allocation Committee and the Special Products Assignment Committee are responsible for reallocating securities that are removed from a trading crowd or DPM pursuant to another rule, or when the trading crowd or DPM for some other reason no longer retains the allocation, subject to Rule 8.80(b)(6), clarifies in a reasonable and efficient way the respective responsibilities of those two committees and other Exchange committees such as the MTS Appointments Committee.

The Commission believes that the CBOE's proposed Rule 8.95, Interpretation .02, which provides that the Allocation Committee is responsible for relocating a trading crowd or DPM which is required to be relocated pursuant to another Exchange rule, clarifies the respective responsibilities

of the Allocation Committee and other Exchange committees.

Finally, the Commission believes that eliminating CBOE Rules 8.80(a) and 8.80(b)(7) current with the effectiveness of proposed CBOE Rule 8.95 will help avoid redundancies that may otherwise cause confusion. The Commission notes that Rule 8.80(b)(8) is made redundant by the elimination of Rule 8.80(b)(7), but the Exchange has stated that it is in the process of proposing to update and reorganize CBOE Rule 8.80, a process which will include the deletion of CBOE Rule 8.80(b)(8).¹²

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-CBOE-98-03), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39880; File No. SR-NASD-98-04]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Mandatory Arbitration of Claims Involving Exempted Securities

April 16, 1998.

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 January 27, 1998,¹ the National Association of Securities Dealers, Inc. ("NASD" or "Association") 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. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹² See Amendment No. 3, *supra* note 3.

¹³ 17 CFR 200.30-3(a)(12).

¹ The NASD filed amendments to the proposed rule change on February 11, and March 31, 1998, the substance of which is incorporated into this notice. See letters from Elliott R. Curzon, Assistant General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated February 6, 1998 ("Amendment No. 1") and March 30, 1998 ("Amendment No. 2").

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

NASD Regulation is proposing to change the interpretation of the NASD's Code of Arbitration Procedure ("Code") such that claims relating to transactions in exempted securities, including government and municipal securities, may be submitted to the Office of Dispute Resolution ("Office") for arbitration under the Code without limitation. Accordingly, when such claims arise involving public customers, Rule 10301 of the Code will require member firms and associated persons to arbitrate them at the request of the customer. In addition, when such claims arise between members and other members or associated persons, Rule 10201 (which governs intra-industry disputes) will require them to be arbitrated at the request of one of the parties. Finally, when such claims arise between a member firm and a customer, customers may be required under the terms of a predispute arbitration agreement to arbitrate the claims.

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

Background. Since at least 1989, the Office has declined to accept claims for mandatory² arbitration involving transactions in exempted securities³ naming member firms that were

² "Mandatory" arbitration is when one party to a dispute is compelled to submit the claim to arbitration by rule or contract. For example, Rule 10201 of the Code requires members and associated persons to arbitrate claims at the request of another member or associated person, and Rule 10301 requires members and associated persons to arbitrate claims at the request of a customer.

³ The term "exempted securities" is defined in Section 3(a)(12) of the Act, 15 U.S.C. 78c(a)(12), to mean government securities, municipal securities, and several other types of securities classified as exempted for specific purposes under the Act.