

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45394; File No. SR-CBOE-2001-64]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange Inc. Relating to AutoQuote Parameters

February 5, 2002.

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 December 17, 2001, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CBOE. 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 CBOE proposes to amend CBOE Rule 8.7 regarding AutoQuote parameters. The text of the proposed rule change is set forth below. Additions are in italics.

#### Chapter VIII: Market-Makers, Trading Crowds and Modified Trading Systems

##### Section A: Market-Makers

##### Rule 8.7 Obligations of Market Makers

(a)-(c) No change.

\* \* \* Interpretations and Policies:

.01-.06 No change.

.07 (a) Market-Makers are expected to participate in and support Exchange-sponsored automated programs, or approved equivalents, including but not limited to the Retail Automatic Execution System and AutoQuote. *AutoQuote is the Exchange's electronic quotation system that automatically monitors and updates market quotations using a mathematical formula measuring certain characteristics of the option and the underlying interest. The formula for generating automatically updated market quotations requires the input of certain components including an option pricing calculation model, volatility, interest rate, dividend, and the measure used to represent the value of the underlying.*

*(b) For those classes in which a DPM, LMM or SMM has been appointed, the responsibility to determine a formula for*

*generating automatically updated market quotations is done by either the DPM pursuant to Rule 8.85(a)(x) or the LMM or SMM pursuant to Rule 8.15. The DPM, LMM or SMM may choose to use either the Exchange's AutoQuote system or a proprietary automated quotation updating systems to monitor and update market quotations. For those option classes in which a DPM, LMM, or SMM has not been appointed, the appropriate Exchange Committee may appoint one or more market-makers in good standing with an appointment in the particular option class to determine a formula for generating automatically updated market quotations for a particular period of time using the Exchange's AutoQuote system or a proprietary automated quotation updating system.*

*(c) For those option classes in which a DPM, LMM, SMM, or appointed market-maker do not have the responsibility set forth in paragraph (b) above, the components in the formula used in each trading crowd to generate automatically updated market quotations shall be as agreed upon by the respective trading crowds. For those classes in which a DPM, LMM, or SMM, or a market-maker in good standing has been appointed the responsibility to determine a formula for generating automatically updated market quotations, the DPM, LMM, SMM or appointed market-maker may, but is not required to, consult with and/or agree with members of the trading crowd in setting the components of the formula, but the members of the trading crowd are not required to provide input in these decisions, and in all instances, the DPM, LMM, SSM, or appointed market-maker has the responsibility to make the final determination as to the components. The provisions of this Interpretation .07 shall also apply to the use of automated quotation updating systems to generate indicative prices that are indications of interest and not firm quotes.*

#### 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 CBOE is submitting the proposed change to Interpretation and Policy .07 to CBOE Rule 8.7 pursuant to subparagraph IV.B.j of the Commission's September 11, 2000 Order,<sup>3</sup> which requires in part that certain options exchanges, including the CBOE, adopt new, or amend existing, rules to make express any practice or procedure "whereby market makers trading any particular option class determine by agreement the spreads or option prices at which they will trade any option class. \* \* \*" The proposed amendment to Interpretation and Policy .07 to CBOE Rule 8.7 would permit market makers to coordinate in setting the components of the formula used by an automated quotation updating system, or Autoquote.<sup>4</sup>

Autoquote is the Exchange's electronic quotation system that automatically monitors and updates market quotations using a mathematical formula measuring certain characteristics of the option and the underlying interest. The formula for generating automatically updated market quotations requires the selection and input of the following components or variables: An option pricing calculation model, volatility, interest rate, dividend, and the measure used to represent the value of the underlying. These Autoquote components may need to be changed during the course of a trading day.

Autoquote is relied upon by all trading crowds to provide automatically updated quotations in options series traded by the crowd. Autoquote provides a means to update the quotes for the tens of thousands of series the Exchange lists.<sup>5</sup> The Commission has recognized "the importance and

<sup>3</sup> See Order Instituting Public Administrative Proceedings Pursuant to section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. Securities Exchange Act Release No. 43268 (September 11, 2000).

<sup>4</sup> For purposes of this filing and the proposed interpretation, the term Autoquote is used to refer to both the Exchange's own automatic quotation system that is offered to trading crowds to generate quotes and to proprietary automated quotation updating systems that are used by trading crowds, DPMs, LMMs, SMMs, or appointed market-makers to generate quotes in lieu of or in addition to the Exchange's own Autoquote system.

<sup>5</sup> Although Autoquote is necessary, individual market-makers can and do manually improve the quote themselves in order to gain a larger share of orders than competing market-makers. In these instances, the manual quote overrides the Autoquote for that particular series.

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

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

efficiencies of automated systems" and that "the Exchange must have the authority to require adequate levels of market maker participation if these systems are going to function efficiently and on a continuous basis."<sup>6</sup>

The CBOE believes that automatic updating of quotes enabled by Autoquote is the bedrock for many of the Exchange's market maker obligations. For example, pursuant to CBOE Rule 8.51, the Exchange trading crowd as a whole is defined as the "responsible broker or dealer" for purposes of the Firm Quote Rule, and thus is obligated to execute a certain number of contracts at the disseminated quote. Accordingly, the CBOE believes that it is very important that the disseminated quote is updated and accurate. Similarly, market makers would not participate in the Exchange's Retail Automatic Execution System ("RAES") if they did not have confidence in the accuracy of the price of orders executed on RAES.

The proposed amendment to Interpretation and Policy .07 to CBOE Rule 8.7 would set forth a more thorough description of Autoquote. The proposed rule change also would identify who has responsibility under Exchange rules to determine a formula for generating automatically updated market quotations. For classes of options in which a DPM is appointed, the DPM would have primary responsibility to determine the formula, which includes determining the components or variables used in the Autoquote formula.<sup>7</sup> For classes of options in which an LMM or SMM is appointed, such as the S&P 100 option class ("OEX"), the LMM or SMM would have primary responsibility to determine the formula for generating automatically updated market quotations.<sup>8</sup> For classes of options in which a DPM, LMM, or SMM has not been appointed, the appropriate Exchange Committee would be permitted to appoint one or more market makers in good standing with an appointment in the particular option class ("Appointed Market-Makers") to

determine a formula for generating automatically updated market quotations, using the Exchange's Autoquote system or a proprietary automated quotation updating system.

Although DPMs, LMMs, SMMs, and Appointed Market-Makers would have the responsibility for determining the formula for generating automatically updated market quotations, the proposed amendment to Interpretation and Policy .07 expressly would provide that the DPM, LMM, SMM, or Appointed Market-Maker may, but is not required to, consult with and/or agree with other market makers in the trading crowd in setting the components or variables of the formula. Conversely, the proposal provides that to the extent a DPM, LMM, SMM, or Appointed Market-Maker determines to consult with and/or agree with the market makers in the trading crowd in setting the components of the Autoquote formula, members of the trading crowd would not be required to provide input to the DPM, LMM, SMM, or Appointed Market-Maker about these decisions.

For classes of options in which a DPM, LMM, SMM or Appointed Market-Maker does not have the responsibility to determine a formula for generating automatically updated market quotations, the market makers would be permitted to coordinate and agree upon the variables for the Autoquote formula. In some trading crowds, one or a few market makers may take responsibility (with the crowd's approval) for updating the Autoquote variables without seeking input on a continual basis. The CBOE believes that such market maker coordination is necessary and appropriate because an Autoquote system is centralized and applicable to all market participants. Thus, the obligations resulting from the quotes generated by Autoquote, such as the firm quote obligation, are imposed on the crowd as a whole.<sup>9</sup> Moreover, although Autoquote is essential to ensure that quotes are updated on the numerous series traded by the Exchange on a timely basis, individual market makers can and do compete among each other to gain a larger share of orders by verbalizing quotes that improve the Autoquote generated quotes. These

verbalized quotes by market makers override the Autoquote generated quotes for the particular series that is the subject of the verbalized quote.

Finally, the amendment to Interpretation .07 also would provide that the provisions described above and set forth in the proposed amendment to Interpretation .07 would also apply to the use of automated quotation updating systems that generate indicative prices that are indications of interest and not firm quotes.<sup>10</sup>

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 5(b) of the Act<sup>11</sup> in general and furthers the objectives of Section 6(b)(5)<sup>12</sup> in particular in that it is designed to promote just and equitable principles of trade, remove impediments to a free and open market and a national market system, and protect investors and the public interest.

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

The Exchange believes that the proposed rule change is procompetitive, because it is necessary to provide for a fair and orderly market in the thousands of option series traded on the Exchange. Accordingly, the Exchange believes the limited joint activity described in this rule proposal is justified by and furthers the objectives of section 11A(a)(1)(C)(ii) of the Act<sup>13</sup> by assuring fair competition among markets. The proposed rule also is consistent with and furthers the objectives of section 6(b)(5) of the Act<sup>14</sup> in that it is designed to remove impediments to a free and open market and protecting investors and the public interest.

### *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.

<sup>6</sup> See Securities Exchange Act Release No. 25787 (June 6, 1988), 53 FR 22083, at 22084 (June 13, 1988).

<sup>7</sup> See CBOE Rule 8.85(a)(x).

<sup>8</sup> On December 17, 2001, the CBOE filed SR-CBOE-2001-63 which amends CBOE Rule 8.15 to make explicit in the rule that the appropriate Market Performance Committee ("MPC") may appoint LMMs and SMMs to determine a formula for generating automatically updated market quotations and use the Exchange's AutoQuote system or a proprietary automated quotation updating system to update market quotations during the trading day in an options class for which a DPM has not been appointed.

<sup>9</sup> CBOE has always used, and the applicable CBOE rules envision, a centralized autoquote system. Although it may be technologically feasible at some point in the future to have a system that would permit each individual market-maker to have his or her own automatic quote updating capability (and although CBOE may eventually develop such a model), CBOE believes that its centralized autoquote system is essential to preserving CBOE's current model of a floor-based, open-outcry market that includes joint crowd obligations pursuant to rules that have been approved by the Commission.

<sup>10</sup> Interpretation and Policy .10 to CBOE Rule 8.7 provides that "[m]arket-makers may display indicative spread prices on the websites of member organizations through a system licensed from a third party, developed by the Exchange or otherwise. Such indicative prices shall not be regarded as firm quotes, and a market-maker shall not be obligated to execute at the indicative prices spread orders that are entered into the market."

<sup>11</sup> 15 U.S.C. 78f(b).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78k-1(a)(1)(C)(ii).

<sup>14</sup> 15 U.S.C. 78f(b)(5).

### 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 CBOE 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 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 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 filings will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2001-64 and should be submitted by March 5, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

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

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45405; File No. SR-CSE-2001-04]

#### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Cincinnati Stock Exchange, Inc. Relating to the Creation of the OTC-UTP System on the Cincinnati Stock Exchange, Inc.**

February 6, 2002.

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 October 31, 2001, the Cincinnati Stock Exchange, Inc. ("CSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Exchange filed an amendment to its proposal on February 5, 2002.<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 Exchange proposes to amend CSE Rule 11.9, National Securities Trading System ("NSTS"), to create a parallel trading system within the Exchange for Nasdaq/National Market securities ("Nasdaq securities"). The Over-the-Counter ("OTC") Unlisted Trading Privileges ("UTP") System ("OTC-UTP System"), while operating on CSE's current hardware and communication lines, will subject CSE users to altered Exchange rules that make the CSE's price/time and agency/principal priorities voluntary for Nasdaq securities. The CSE believes that the proposed rule change will enhance the competitive position of the Exchange by promoting increased liquidity and greater opportunities for members and their customers to obtain best execution on the CSE. The text of the proposed rule change is available at the principal offices of the Exchange and at the Commission.

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

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

<sup>3</sup> See letter from Jeffrey T. Brown, Senior Vice President, Secretary and General Counsel, CSE, to Katherine England, Assistant Director, Division of Market Regulation, Commission (February 5, 2002) ("Amendment No. 1").

#### **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 Exchange 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 Exchange 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 change its rules to create the OTC-UTP System within the CSE that will provide CSE members with increased flexibility to provide best execution to their customers' orders. In order to more effectively compete for order flow in Nasdaq securities, CSE is proposing to amend its price/time and agency/principal priority rules such that CSE users ("Users")<sup>4</sup> may voluntarily and on an order-by-order basis determine to interact with other bids, offers, and orders displayed in CSE's OTC-UTP System. CSE believes that the new trading system is consistent with the federal securities laws and similar in nature to that currently employed by the Nasdaq Stock Market, Inc. ("Nasdaq") and as proposed in the Nasdaq's exchange filing.<sup>5</sup>

##### **Description**

The CSE's current trading system, NSTS, is an electronic securities communication and execution facility, that combines the display of bids, offers, and orders of Users as well as orders on the NSTS central limit order book ("CLOB") with the matching and execution of like-priced orders, bids, and offers according to programmed price/time and agency/principal priorities.<sup>6</sup> The price/time and agency/principal priority rules are set forth in CSE Rules 11.9(i), (l), (m), and (u).

Rule 11.9(i) states that NSTS shall automatically match and execute like-priced orders, bids and offers in accordance with the price/time and agency/principal priorities set forth in

<sup>4</sup> CSE Rule 11.9(a)(7) defines the term "User" as a Member of the Exchange or an Approved Dealer.

<sup>5</sup> See Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001).

<sup>6</sup> CSE Rule 11.9(a)(1).

<sup>15</sup> 17 CFR 200.30-3(a)(12).