

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50755; File No. SR-CBOE-2004-77)

November 30, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to the Systematizing of Orders in Connection with the Requirement to Design and Implement a Consolidated Options Audit Trail System (“COATS”)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 24, 2004, 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. 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

CBOE proposes to amend its rules relating to the systematizing of orders in connection with the requirement to design and implement a consolidated options audit trail system (“COATS”). The text of the proposed rule change is provided below. Proposed additions are in underlined and proposed deletions are in brackets.

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CHAPTER VI

Section B: Member Activities on the Floor

[Orders Required to Be in Written Form] Required Order Information

Rule 6.24

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(a) [Transmitted to the Floor. Each order transmitted to the floor must be recorded legibly in a written form that has been approved by the Exchange, and the member receiving such order must record the time of its receipt on the floor. Each such order must be in legible written form when taken to the post for attempted execution.] Orders Must Be Systematized. The Exchange has undertaken with the other options exchanges to develop a Consolidated Options Audit Trail System (“COATS”), which when fully developed and implemented, will provide an accurate, time-sequenced record of electronic and other orders, quotations, and transactions in certain option classes listed on the Exchange. Unless otherwise provided, the requirements of this Rule shall commence on January 10, 2005. In connection with the implementation of COATS:

(1) Except as provided in paragraphs (a)(2) through (a)(4), and (b), of this Rule, each order, cancellation of, or change to an order transmitted to the Exchange must be “systematized”, in a format approved by the Exchange, either before it is sent to the Exchange or upon receipt on the floor of the Exchange. An order is systematized if: (i) the order is sent electronically to the Exchange; or (ii) the order that is sent to the Exchange non-electronically (e.g., telephone orders) is input electronically into the Exchange’s systems contemporaneously upon receipt on the Exchange, and prior to representation of the order.

(2) Market and Marketable Orders. With respect to non-electronic, market and marketable orders sent to the Exchange, the member responsible for systematizing the order shall input into the Exchange’s systems at least the following specific information with respect to the order prior to the representation of the order: (i) the option symbol; (ii) the expiration month; (iii) the expiration year; (iv) the strike price; (v) buy or sell; (vi) call or put; (vii) the number of contracts; and (viii) the Clearing Member. Any additional information with respect to the order shall be input into the Exchange’s systems

contemporaneously upon receipt, which may occur after the representation and execution of the order.

(3) Orders in Certain Index Option Classes. The requirement to systematize orders as set forth in this Rule shall commence on March 28, 2005, in the following option classes: the S&P 500 index option class (SPX), the S&P 100 index option class (OEX), and the European-style S&P 100 index option class (XEO).

(4) In the event of a malfunction or disruption of the Exchange's systems such that a member is unable to systematize an order, the member or member organization shall follow the procedures as described in paragraph (b) of this Rule during the time period that the malfunction or disruption occurs. Upon the cessation of the malfunction or disruption, the member shall immediately resume systematizing orders. In addition, the member shall exert best efforts to input electronically into the Exchange's systems all relevant order information received during the time period when there was a malfunction or disruption of the Exchange's systems as soon as possible, and in any event shall input such data electronically into the Exchange's systems not later than the close of business on the day that the malfunction or disruption ceases. If, following a malfunction or disruption, the Exchange's systems were to become available for the systemization of orders after the close of business, the member would be expected to input electronically into the Exchange's systems all relevant order information received during the malfunction or disruption on the next business day.

(b) With respect to orders received during a malfunction or disruption of the Exchange's systems under paragraph (a)(4) above:

(1) Transmitted to the Floor. Each order transmitted to the Exchange must be recorded legibly in a written form that has been approved by the Exchange, and the

member receiving such order must record the time of its receipt on the floor and legibly record the terms of the order, in written form.

(2) Cancellations and Changes. Each cancellation of, or change to, an order that has been transmitted to the floor must be recorded legibly in a written form that has been approved by the Exchange, and the member receiving such cancellation or change must record the time of its receipt on the floor.

(c) Executions. A member transmitting from the floor a report of the execution of an order must record the time at which a report of such execution is received by such member.

[(d) On-floor Market-Maker Orders. Each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, must be recorded legibly in a written form that has been approved by the Exchange, and must be time stamped immediately prior to its transmission.]

... Interpretations and Policies:

.01 Any member desiring to use an order form other than those provided by the Exchange must submit such form to the appropriate Floor Procedure Committee and obtain its approval prior to using such form on the Floor. When approving an order form other than those provided by the Exchange, the appropriate Floor Procedure Committee shall ensure that the form complies with COATS.

.02 [(a) Without limiting the applicability of the foregoing, the] The use of hand signal communications on the floor of the Exchange may be used to initiate an order, to increase or decrease the size of an order, to change an order's limit, to cancel an order, or to activate a market order. [Unless an options class is exempted by the Exchange, any] Any initiation, cancellation, or change of an order relayed to a floor broker through the use of hand signals also must be systematized in accordance with paragraph (a) of this Rule[relayed to the floor broker in

written form, time-stamped, immediately thereafter]. All other rules applicable to order preparation and retention, and reporting duties are applicable to orders [in exempted option classes] under this Interpretation, except that the record-keeping obligation lies with the member signaling the order where a hand signal is used. All cancellations and changes of orders held by the [Board Broker or] Order Book Official must be provided in written form or electronically, and also must be systematized in accordance with paragraph (a) of this Rule.

[(b) Until further notice the following are exempt options classes under this Interpretation: OEX, SPX, NSX, and DJX.]

.03 The appropriate Floor Procedure Committee will from time to time prescribe the form of Telephone and Terminal Order Formats in a Manual and the contents of this Manual are hereby incorporated in these Rules and will have full force and effect as if fully set forth herein. The Telephone and Terminal Order Formats in the Manual shall comply with the requirements of COATS.

.04 Accommodation liquidations as described in Rule 6.54 are exempt from the requirements of this Rule. However, the Exchange maintains quotation, order and transaction information for accommodation liquidations in the same format as the COATS data is maintained, and will make such information available to the SEC upon request.

.05 FLEX options, as described in Chapter 24A of the Exchange's rules, are exempt from the requirements of this Rule. However, the Exchange will maintain as part of its audit trail quotation, order and transaction information for FLEX options in a form and manner that is substantially similar to the form and manner as the COATS data is maintained, and will make such information available to the SEC upon request.

.06 Any proprietary system approved by the Exchange on the Exchange's trading floor which receives orders will be considered an Exchange system for purposes of paragraph

(a)(1) of this Rule. Any proprietary system approved by the Exchange shall have the functionality to comply with the requirements of COATS.

.07 On-floor Market-Maker Orders. Each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, must be systematized in accordance with the procedures described in Paragraph (a) and (b) of this Rule, as applicable.

Rule 6.73 Responsibilities of Floor Brokers

(a) – (d) No change.

... Interpretations and Policies:

.01 - .03 No change.

.04 Pursuant to Rule 6.73(a), and subject to the requirement to systematize orders prior to representation pursuant to Rule 6.24, a Floor Broker's use of due diligence in handling an order shall include the immediate and continuous representation at the trading station where the option class represented by the order is traded, any of the following types of orders: (1) market orders, (2) limit orders to sell where the specified price is at or below the current offer or, (3) limit orders to buy where the specified price is at or above the current bid.

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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 parts of such statements.

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

1. Purpose

CBOE proposes this rule change to comply with the requirement to implement COATS. In connection with the filing of this proposed rule change, CBOE is withdrawing SR-CBOE-2003-18, and Amendment Nos. 1 and 2 thereto, which CBOE previously filed to comply with the requirement to implement COATS.³

Specifically, CBOE is submitting the proposed change to Rule 6.24 in connection with subparagraph IV.B.e(v) of the Commission's September 11, 2000 Order ("Order"),⁴ which requires the options exchanges to design and implement COATS to "incorporate into the audit trail all non-electronic orders such that the audit trail provides an accurate, time-sequenced record of electronic and other orders, quotations and transactions on such respondent exchange, beginning with the receipt of an order by such respondent exchange and further documenting the life of the order through the process of execution, partial execution, or cancellation of that order..." ("Phase V").

In order to assure that all non-electronic orders are incorporated into COATS for Phase V, the proposed rule change proposes to amend CBOE Rule 6.24, which currently requires orders to be in written form. The proposed rule change generally requires that each order, change to an order, or cancellation of an order transmitted to the Exchange must be "systematized," in a format approved by the Exchange, either before it is sent to the Exchange or contemporaneously upon receipt on the floor of the Exchange, and prior to representation of the

³ Amendment No. 1 to SR-CBOE-2003-18 superceded the original filing in its entirety, and was published for comment by the SEC on July 31, 2003. See Securities Exchange Act Release No. 48267 (August 1, 2003), 68 FR 47116 (August 8, 2003).

⁴ Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. See Securities Exchange Act Release No. 43268 (September 11, 2000).

order.⁵ Each order, change to an order, or cancellation of an order may be systematized in one of two ways. If an order, change to an order, or cancellation of an order is sent electronically to the Exchange, it is systematized. Alternatively, if an order, change to an order, or cancellation of an order that is sent to the Exchange non-electronically is input electronically into the Exchange's systems contemporaneously upon receipt on the Exchange, it is systematized.⁶ The proposed rule states that this requirement will commence on January 10, 2005.

Although the proposed rule change generally requires that each order be systematized prior to representation, the Exchange believes that it is appropriate and necessary to treat market and marketable orders differently than other orders so that marketable orders may be represented immediately in the marketplace as customers expect and as members representing those orders are obligated to do.⁷ Accordingly, with respect to non-electronic market and marketable orders sent to the Exchange, the proposed rule change provides that the member responsible for systematizing the order shall input into the Exchange's systems a number of order terms that are sufficient to distinguish one order from another order that a member may receive at or about the same time to ensure an accurate audit trail. Accordingly, the proposed rule change requires that a member input into the Exchange's systems the following specific information with respect to a

⁵ CBOE notes that the execution or partial execution of an order has been incorporated into COATS in Phase II, and as described in Paragraph II of the formal COATS Plan that the options exchanges previously have provided to the SEC.

⁶ The Exchange recognizes the need for effective and proactive surveillance for activities such as trading ahead and front-running. It currently conducts surveillance for such activities and will incorporate a review of order systemization as part of such surveillance. The Exchange also intends to implement supplementary surveillance and examination programs related to the systemization of orders requirement promptly after this requirement is instituted, and which will support, among other things, trading ahead and front-running surveillances.

⁷ CBOE Rule 6.73(a) requires that "[a] floor broker handling an order is to use due diligence to execute the order at the best price or prices available to him." Interpretation .04 to Rule 6.73 further clarifies a broker's obligation to exercise due diligence, stating "Pursuant to Rule 6.73(a), a Floor Broker's use of due diligence in handling an order shall include the immediate and continuous representation, at the trading station where the option class represented by the order is traded, any of the following types of orders: (1) market orders, (2) limit orders to sell where the specified price is at or below the current offer or, (3) limit orders to buy where the specified price is at or above the current bid."

market or marketable order prior to the representation of the order: (i) the option symbol; (ii) the expiration month; (iii) the expiration year; (iv) the strike price; (v) buy or sell; (vi) call or put; (vii) the number of contracts; and (viii) the Clearing Member.⁸ Any additional information with respect to the order shall be input into the Exchange's systems contemporaneously thereafter, which may occur after the representation and execution of the order.

This requirement for market and marketable orders necessarily requires the member receiving the market or marketable order to balance the requirement to immediately systematize non-electronic orders for audit trail purposes with the member's obligation under CBOE rules,⁹ the federal securities laws, and common law agency principles to immediately and continuously represent market and marketable customer orders.¹⁰ Because the requirement to systematize market and marketable orders will affect a member's ability to immediately represent market and marketable customer orders, the Exchange is also proposing to amend Interpretation .04 to CBOE Rule 6.73 - Responsibilities of Floor Brokers, to make explicit that a broker's responsibility to immediately and continuously represent market and marketable orders is subject to the requirement set forth in this rule change, namely, that each order must be systematized prior to representation.

With respect to non-electronic orders received in the S&P 100 index option class (OEX), the S&P 500 index option class (SPX), and the European-style S&P 100 index option class (XEO), the proposed rule change states that the requirement to systematize orders prior to

⁸ The "Clearing Member" means the CBOE clearing member firm that is required to be identified for each transaction on the Exchange pursuant to Rule 6.51(d). See Rule 1.1(f) defining "Clearing Member".

⁹ See CBOE Rule 6.73.

¹⁰ Following implementation of this rule change on would be sufficient to distinguish one order from another January 10, 2005, the Exchange intends to analyze whether some number of orders terms less than the eight identified above that a member may receive at or about the same time. If the Exchange's analysis supports eliminating the necessity to input some of these order terms prior to representation, the Exchange may propose to amend this requirement, which would be subject to Commission review and approval.

representation shall commence on March 28, 2005. The Exchange believes that the exception for these option classes is reasonable and appropriate because the manner in which these option classes trade is significantly different than equity option classes and because of the trading environment that exists in these option classes.¹¹

Additionally, in proposed new subparagraph (a)(4) of CBOE Rule 6.24, the Exchange proposes that in the event of a malfunction or disruption of the Exchange's systems such that a member is unable to systematize an order, the member or member organization shall follow the procedures as described in paragraph (b) of CBOE Rule 6.24 during the time period that the malfunction or disruption occurs. Upon the cessation of the malfunction or disruption, the member shall immediately resume systematizing orders. In addition, the member shall exert best efforts to input electronically into the Exchange's systems all relevant order information received during the time period when there was a malfunction or disruption of the Exchange's systems as soon as possible, and in any event shall input such data electronically into the Exchange's systems not later than the close of business on the day that the malfunction or disruption ceases.¹²

The proposed rule change also keeps the current Interpretation and Policy .02(a) of CBOE Rule 6.24, which permits the use of hand signal communications on the floor to, among other things, initiate an order, cancel an order or to change material terms of an order. However,

¹¹ As CBOE has advised the SEC staff, CBOE initially developed its floor broker workstation ("FBW") to assist its members in complying with their obligations to systematize orders for COATS. However, the FBW was designed specifically for COATS compliance in equity option classes, and not for use in index option classes. Upon being advised in late December 2003 that the requirement to systematize orders also applied to non-equity option classes, the Exchange actively pursued developing an alternative technology to utilize in index option classes.

¹² If, following a malfunction or disruption, the Exchange's systems were to become available for the systemization of orders after the close of business, the member would be expected to input electronically into the Exchange's systems all relevant order information received during the malfunction or disruption on the next business day.

any initiation, cancellation, or change of an order relayed to a floor broker through the use of hand signals also must be systematized upon receipt in accordance with paragraph (a) of CBOE Rule 6.24. The proposed rule change also deletes paragraph (b) of Interpretation .02 as paragraph (a) of that interpretation is being amended to delete the reference to exempt classes.

The Exchange has added a new Interpretation and Policy .04 to CBOE Rule 6.24, which states that accommodation liquidations as defined in Rule 6.54 are exempted from the systematization requirement. However, the Exchange maintains quotation, order and transaction information for accommodation liquidations in the same format as the COATS data is maintained, and will make such information available to the SEC upon request.

The Exchange also has added a new Interpretation and Policy .05 to CBOE Rule 6.24, which states that FLEX options, as described in Chapter 24A of the Exchange's rules, are exempt from the requirements of this Rule. However, the Exchange will maintain as part of its audit trail quotation, order and transaction information for FLEX options in a form and manner that is substantially similar to the form and manner as the COATS data is maintained, and will make such information available to the SEC upon request.

The proposed rule change also includes a new Interpretation .06 which provides that any proprietary system approved by the Exchange on the Exchange's trading floor that receives orders will be considered an Exchange system for purposes of paragraph (a)(1) of this Rule. Any proprietary system approved by the Exchange shall comply with the requirements of COATS.

Finally, the proposed rule change includes a new Interpretation .07 which provides that each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, must be systematized in accordance with the procedures described in Paragraph (a) and (b) of this Rule, as applicable. Currently paragraph (d) of CBOE Rule 6.24

requires that each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, must be recorded legibly in a written form that has been approved by the Exchange, and must be time stamped immediately prior to its transmission.

This new interpretation thus requires that each order transmitted by a Market-Maker while on the floor, including any cancellation of or change to such order, is systematized in accordance with CBOE Rule 6.24.

2. Statutory Basis

CBOE believes the proposed rule change is consistent with Section 6(b) of the Act¹³ in general and furthers the objectives of Section 6(b)(5)¹⁴ in particular in that it should promote just and equitable principles of trade, and protect investors and the public interest. CBOE believes that the proposed rule change will promote just and equitable principles of trade and protect investors and the public interest by electronically enhancing the audit trail for orders by incorporating non-electronic orders into COATS. This enhanced audit trail will permit CBOE to conduct surveillance of the activity on the Exchange and reconstruct markets in a more efficient and effective manner.

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

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

The Exchange neither received nor solicited written comments on the proposed rule change.

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

¹³ 15 U.S.C. 78f(b).

¹⁴ 15 U.S.C. 78(b)(5).

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 self-regulatory organization 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. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2004-77 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-77. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2004-77 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Margaret H. McFarland
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).