

plan allows an SRO participant that has been allocated regulatory responsibilities under the plan (*i.e.*, a DOEA) to contract with The Options Clearing Corporation, a national securities exchange registered under section 6(a) of the Act,¹⁴ or a national securities association registered under section 15A of the Act¹⁵ to perform the DOEA's responsibilities under the plan.

II. Discussion

The Commission continues to believe that the proposed plan, as amended, is an achievement in cooperation among the SRO participants and will reduce unnecessary regulatory duplication by allocating to the designated SRO the responsibility for certain options-related sales practice matters that would otherwise be performed by multiple SROs. The plan promotes efficiency by reducing costs to firms that are members of more than one of the SRO participants. In addition, because the SRO participants coordinate their regulatory functions in accordance with the plan, the plan promotes, and will continue to promote, investor protection.

With respect to the DOEA's ability to contract with another SRO to perform the DOEA's regulatory responsibilities under the plan, the Commission has previously recognized that contractual regulatory agreements between SROs outside of the Rule 17d-2 context may be permissible in instances where it is consistent with the public interest.¹⁶ The Commission believes that it is reasonable and consistent with the public interest to allow an SRO to contract with another SRO to perform regulatory functions and services. At the same time, the Commission believes that it is important for, and that the Act requires, the ultimate responsibility and primary liability for self-regulatory failures to rest with the DOEA itself, rather than the SRO retained to perform the regulatory responsibilities. Thus, the DOEA will bear ultimate legal responsibility for the performance of the regulatory responsibilities allocated to it under the 17d-2 plan. The SRO contracting to carry out the responsibilities, however, may nonetheless bear liability for causing or, in appropriate circumstances, aiding and abetting the DOEA's violations.

This order gives effect to the amended plan submitted to the Commission that is contained in File No. S7-966. The SRO participants shall notify all

members affected by the amended plan of their rights and obligations under the amended plan.

It is therefore ordered, pursuant to sections 17(d) and 11A(a)(3)(B) of the Act, that the amended plan of the Amex, the CBOE, the ISE, the NASD, the NYSE, the PCX, and the Phlx filed pursuant to Rule 17d-2 is approved.

It is further ordered that those SRO participants that are not the DOEA as to a particular member are relieved of those responsibilities allocated to the member's DOEA under the amended plan.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to an Extension of the Permissible Maturity of Flexible Exchange Index Options to Ten Years

November 12, 2002.

[Release No. 34-46815; File No. SR-CBOE-2002-23]

On April 30, 2002, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to revise CBOE Rule 24A.4, "Terms of FLEX Options," to provide a maximum term of up to ten years for Flexible Exchange ("FLEX") index options³ under certain circumstances.

The proposed rule change was published for comment in the **Federal Register** on August 21, 2002.⁴ No comments were received regarding the proposal. This order approves the proposed rule change.

Currently, CBOE Rule 24A.4(a)(4)(i) provides a maximum term of five years for FLEX index options. The CBOE proposes to amend CBOE Rule 24A.4(a)(4)(i) to provide a maximum

term of up to ten years for FLEX index options, provided that the FLEX Post Official determines that sufficient liquidity exists among FLEX index participating members to support a request for a quote for such options. To determine whether sufficient liquidity exists to support a request for a quote, the FLEX Post Official will ask FLEX index market makers and other FLEX index traders (including the Submitting Member) whether they are interested in making a two-sided market in the proposed series for the size requested.⁵ If the FLEX index market makers and FLEX index traders respond affirmatively, the FLEX Post Official will open a Request for Quotes for the proposed series, which will trade pursuant to the provisions of CBOE Rule 24A.5, "FLEX Trading Procedures and Principles."⁶ The CBOE believes that this requirement will help to prevent the proliferation of longer-term FLEX index options where there is no interest in trading such options.

The margin requirements for the proposed FLEX index options will be the same as the margin requirements that apply currently to existing FLEX index options and to other listed options.⁷ Thus, the required minimum initial and maintenance margin for a proposed FLEX index option with more than nine months to expiration will be at least 75% of the current market value of the option.⁸ The required minimum initial and maintenance margin for a short position in the proposed FLEX index options will be the same as the margin required for short positions in other listed broad-based index options.⁹

According to the CBOE, the Exchange has received numerous requests from broker-dealers to extend the maturity of FLEX index options to ten years to permit their institutional customers that trade or issue securities with five-to-ten-year terms to hedge their long-term risk. The CBOE states that the proposal will allow institutions to use long-term FLEX

⁵ See letter from Jaime Galvan, Attorney II, CBOE, to Yvonne Fraticelli, Division of Market Regulation, Commission, dated October 14, 2002 ("October 14 Letter").

⁶ See October 14 Letter, *supra* note 5.

⁷ See October 14 Letter, *supra* note 5.

⁸ See CBOE Rule 12.3(c)(4)(B).

⁹ See October 14 Letter, *supra* note 5. Under the CBOE's rules, the required minimum initial and maintenance margin for an unhedged position in a listed broad-based index option carried short in a customer's account is 100% of the current market value of the option plus 15% of the product of the current index group value and the applicable index multiplier, reduced by any out-of-the-money amount, with a minimum margin requirement equal to 100% of the current market value of the option plus 10% of the product of the current index group value and the applicable index multiplier. See CBOE Rule 12.3(c)(5)(A).

¹⁴ 15 U.S.C. 78f(a).

¹⁵ 15 U.S.C. 78o-3.

¹⁶ See Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11401 (March 2, 2000).

¹⁷ 17 CFR 200.30-3(a)(34).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ FLEX index options allow investors to customize certain option terms, including size, expiration date, exercise style, and exercise price.

⁴ See Securities Exchange Act Release No. 46363 (August 15, 2002), 67 FR 54243.

index options to protect their portfolios from long-term market moves at a known and limited cost. In addition, the CBOE believes that the proposal will better serve the long-term hedging needs of institutional investors and provide those investors with an alternative to hedging their portfolios with off-exchange customized index options and warrants.

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 Act¹⁰ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with the requirements under section 6(b)(5) of the Act¹¹ that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and to protect investors and the public interest.¹²

The Commission believes that extending the permissible maturity of FLEX index options to a maximum term of up to ten years will help to meet the long-term hedging requirements of institutional investors and other market participants.¹³ The proposal should benefit market participants with long-term hedging needs by allowing them to hedge positions on a long-term basis through an investment in one option series, rather than having to roll shorter-term expirations into new series to remain hedged over an extended period of time. In addition, the proposal will allow market participants to hedge long-term risk with an exchange-traded option, thereby providing an alternative to hedging positions with over-the-counter ("OTC") products and extending the benefits of a listed, exchange market to longer-term index

options.¹⁴ The extension of the permissible maturity term for FLEX index options to up to ten years also could help to expand the depth and liquidity of the FLEX index option market.

The Commission notes that a series of the proposed FLEX index options may be issued only if a FLEX Post Official determines that there is sufficient liquidity among FLEX index participating members to support the request for a quote for such options. This requirement should help to prevent the proliferation of longer term FLEX index options series where there is no interest in trading such options. In addition, as with all exchange-traded options, the OCC will act as the counterparty guarantor, thereby ensuring that obligations will be met over the long term. In approving this proposal, the Commission notes that the extension to ten years is based, in part, on the nature of the FLEX market, which is geared toward institutional investors and high net worth individuals.¹⁵ The Commission believes that because of their experience, these market participants may be better able to assess the risks of longer term index option products.¹⁶

For the foregoing reasons, the Commission finds that the proposal is consistent with the requirements of the Act and rules and regulations thereunder.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,¹⁷ that the proposed rule change (SR-CBOE-2002-23) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Margaret H. McFarland,

Deputy Secretary.

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¹⁴ As the Commission has noted previously, the benefits of the CBOE's market versus an OTC market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, standardized contract specifications, parameters and procedures for clearance and settlement, and the guarantee of the Options Clearing Corporation ("OCC") for all contracts traded on the CBOE. See Securities Exchange Act Release No. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993) (File No. SR-CBOE-92-17) (approving the CBOE's proposal to list and trade FLEX options on the S&P 500 Index and the S&P 100 Index).

¹⁵ See note 13, *supra*.

¹⁶ See also note 12 in Securities Exchange Act Release No. 39524 (January 8, 1998), 63 FR 3009 (January 20, 1998) (order approving File No. SR-CBOE-97-57) (noting certain concerns that may be raised by long-term options).

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46808; File No. SR-CBOE-2002-30]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change Amending Rule 8.85(a)(xi) and Rule 17.50 To Require Members To Use and Maintain CBOE's AutoQuote System as a Back-up Quoting System

November 12, 2002.

I. Introduction

On June 11, 2002, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending Rule 8.85(a)(xi) and Rule 17.50 to require Exchange members to use and maintain CBOE's AutoQuote System as a back-up quoting system. On September 3, 2002 the Exchange filed Amendment No. 1 to the proposed rule change.³ The proposed rule change was published for public comment in the **Federal Register** on October 3, 2002.⁴ The Commission received no comments on the proposal. This order approves the proposal, as amended.

II. Description of the Proposed Rule Change

The Exchange is adopting new Rule 8.85(a)(xi) which states that, with respect to a Designated Primary Market-Maker ("DPM") trading station utilizing a proprietary autoquote system, such DPM is obligated to assure that the CBOE AutoQuote system is maintained as a back-up autoquote system at all times during market hours. While many DPMs utilize CBOE's AutoQuote system, some DPMs have opted to use non-CBOE proprietary automated quotation updating systems. CBOE has allowed members to employ proprietary autoquote systems provided such systems are approved by the Exchange's appropriate Floor Procedure Committee. The failure of a proprietary autoquote system could result in CBOE's inability to open for an entire group of listed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Angelou Evangelou, Senior Attorney, CBOE, to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated August 30, 2002.

⁴ Securities Exchange Act Release No. 46539 (September 24, 2002), 67 FR 62084.

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

¹² In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹³ FLEX index options are designed to appeal to institutional investors or extremely high net worth individuals who have the experience and ability to engage in negotiated, customized transactions. In this regard, the Commission notes that the required minimum size for an opening transaction in any FLEX index option series in which there is no open interest is \$10 million Underlying Equivalent Value (the aggregate underlying monetary value covered by that number of contracts, derived by multiplying the index multiplier by the current index value times the given number of FLEX index options). See CBOE Rule 24A.4(a)(4)(ii).