

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 Act<sup>10</sup> 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 Act<sup>11</sup> 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.<sup>12</sup>

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.<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup>

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,<sup>17</sup> that the proposed rule change (SR-CBOE-2002-23) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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<sup>14</sup> 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).

<sup>15</sup> See note 13, *supra*.

<sup>16</sup> 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).

<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</sup> 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")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> 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.<sup>3</sup> The proposed rule change was published for public comment in the **Federal Register** on October 3, 2002.<sup>4</sup> 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

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

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

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

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

<sup>10</sup> 15 U.S.C. 78f(b).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> 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).

<sup>13</sup> 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).

option classes for a brief or sometimes lengthy time period. Thus, CBOE strongly encouraged, and now requires, that members have CBOE's AutoQuote system ready as a back-up should a proprietary system fail. The Exchange also proposes to add subparagraph (g)(10) to CBOE Rule 17.50—Imposition of Fines for Minor Rule Violations, to incorporate in its Minor Rule Violation Plan violations of new Rule 8.85(a)(xi).

### III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with section 6 of the Act<sup>5</sup> and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change is consistent with section 6(b)(5) of the Act<sup>6</sup> which requires, among other things, that the rules of the exchange be designed to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The proposed rule change is also consistent with section 6(b)(6) of the Act,<sup>7</sup> which generally requires that the Exchange provide for the appropriate discipline of its members, and Rule 19d-1(c)(2) under the Act,<sup>8</sup> which governs minor rule violation plans.

The proposed rule change removes impediments to and perfects the mechanism of a free and open market because by requiring members of the Exchange to maintain CBOE's AutoQuote system as a back-up, the Exchange provides a mechanism for ensuring the smooth and uninterrupted operation of the Exchange in the event of a failure by a member's proprietary autoquote system. Without CBOE's AutoQuote system in place as a back-up, the Exchange might be unable to open trading for an entire group of listed option classes if a proprietary autoquote system fails. Requiring members to maintain CBOE's AutoQuote system as a back-up would avoid such disruptions, which in turn would benefit investors and the public interest.

The Commission also finds that adding Rule 8.85(a)(xi) to the list of violations included in the Exchange's Minor Rule Violation Plan ("Plan") is consistent with requirements of Section 6(b)(6) of the Act<sup>9</sup> because it provides an additional option for the appropriate

discipline of Exchange members. The Commission notes that while the Plan provides the Exchange with the option of proceeding under the Plan against a member found to be in violation of a rule included in the Plan, the Exchange must continue to conduct surveillance of its members and ensure their compliance with the Exchange's rules, and to proceed with formal disciplinary action if a particular case warrants such action. Finally, the Commission finds that the addition of Rule 8.85(a)(xi) to the list of violations included in the Exchange's Plan is consistent with Rule 19d-1(c)(2) under the Act,<sup>10</sup> which governs minor rule violation plans because the Plan provides an efficient means to punish violations of Exchange rules, consistent with the public interest and the protection of investors.

### IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>11</sup> that the proposed rule change (SR-CBOE-2002-30), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

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

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46814; File No. SR-ISE-2002-23]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the International Stock Exchange, Inc. To Amend Rule 720 Regarding Options Priced Under \$3.00

November 12, 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 16, 2002, the International Stock Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this

notice to solicit comments on the proposed rule change.

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

The Exchange is proposing to amend Rule 720 (the "Obvious Error Rule") as it pertains to transactions in options priced under \$3.00. The text of the proposed rule change is set forth below. Proposed new language is *italicized*; proposed deletions are in brackets.

\* \* \* \* \*

#### Rule 720. Obvious Errors

The Exchange shall either bust a transaction or adjust the execution price of a transaction that results from an Obvious Error as provided in this Rule.

(a) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when:

(1) if the Theoretical Price of the option is less than \$3.00[.];

(i) *during regular market conditions (including rotations)* the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of [25] 35 cents or more; or

(ii) *during fast market conditions (i.e., the Exchange has declared a fast market status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of 50 cents or more.*

(2) if the Theoretical Price of the option is \$3.00 or higher:

(i) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least two (2) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more; or

(ii) *during fast market conditions (i.e., the Exchange has declared a fast market status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least three (3) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more.*

\* \* \* \* \*

### 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 the proposed rule change and discussed any comments it received on the proposed

<sup>5</sup> 15 U.S.C. 78f.

<sup>6</sup> 15 U.S.C. 78f(b)(5).

<sup>7</sup> 15 U.S.C. 78f(b)(6).

<sup>8</sup> 17 CFR 240.19d-1(c)(2).

<sup>9</sup> 15 U.S.C. 78f(b)(6).

<sup>10</sup> 17 CFR 240.19d-1(c)(2).

<sup>11</sup> 15 U.S.C. 78s(b)(2).

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

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

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