

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

1. Purpose

Since at least the 1980s,⁷ the Commission has expressed concerns regarding potential information advantages and potential opportunities for manipulation that might occur if specialists and market makers could engage in side-by-side trading and integrated market making.

In October of 1990, the Commission approved CBOE rules governing the trading of stocks, warrants, and other securities at CBOE (which are now set forth in Chapter 30 of the CBOE's Rules).⁸ During the process of obtaining this approval, CBOE noted to the Commission that no side-by-side trading of stocks and stock options would occur on the same floor, and agreed to submit a proposed rule change under section 19(b) of the Act⁹ to the Commission "prior to any modification to its plan to trade stocks in a separate location from the options trading floor."¹⁰ In addition, Exchange Rule 30.18(a), as proposed by the CBOE and approved by the Commission, was "intended to prevent a member from buying or selling an underlying stock on the CBOE when the member or an affiliate has a position in an option or warrant on that security."¹¹

Since that time, the core of the CBOE's business has remained primarily in listed options on equities and stock indexes. In recent years, however, the CBOE, in addition to its existing listed options business, has also come to trade a number of products that derive their value from portfolios of other equity securities. These products include among others, Index Portfolio Receipts ("IPRs")¹² and "Index Portfolio

Shares ("IPSS"),¹³ which are sometimes collectively referred to as Exchange-Traded Funds ("ETFs"),¹⁴ as well as Trust Issued Receipts ("TIRs").¹⁵

More recently, the Commission approved the American Stock Exchange LLC ("Amex") filing SR-Amex-2002-21, which authorized the Amex to permit limited integrated market making in its stocks that trade pursuant to unlisted trading privileges ("UTP") and their related options, as well as both integrated market making and side-by-side trading in certain ETF shares and TIRs and their related options.¹⁶

CBOE expressed concerns about the Amex proposal for side-by-side trading set forth in SR-Amex-2002-21 and the earlier SR-Amex-2001-75.¹⁷ Furthermore, the CBOE believes the Commission's recent approval of SR-

will pay to the redeeming holder the stock and cash then comprising the Portfolio Deposit; and (d) pay holders a periodic cash payment corresponding to the regular cash dividends or distributions declared and paid with respect to the component securities of the stock index on which the IPRs are based, less certain expenses and other charges as set forth in the Trust prospectus. IPRs are "UIT interests" within the meaning of the Rules of the Exchange.

¹³ As set forth in Interpretation .03 to CBOE Rule 1.1, the term "Index Portfolio Shares" or IPSS means securities that (a) are issued by an open-end management investment company based on a portfolio of stocks designed to provide investment results that correspond generally to the price and yield performance of a specified foreign or domestic stock index; (b) are issued by such an open-end management investment company in a specified aggregate minimum number in return for a deposit of specified number of shares of stock and/or a cash amount with a value equal to the next determined net asset value; and (c) when aggregated in the same specified minimum number, may be redeemed at a holder's request by such open-end management investment company which will pay to the redeeming holder stock and/or cash with a value equal to the next determined net asset value.

¹⁴ For ease of reference, this rule filing uses the term Exchange-Traded Fund, or ETF, to describe both IPRs and IPSSs. Currently, the Exchange trades the following ETFs listed on the CBOE pursuant to CBOE Rule 31.5(L)-(M): the Nasdaq 100® Index Tracking Stock ("QQQ"), the Standard & Poor's® Depository Receipts (SPY-SPDRs®), and the S&P 100 iSharesSM ("OEF"). See email from Christopher Hill, Attorney, CBOE, to Christopher Solgan, Attorney, Division, Commission, dated November 12, 2002.

¹⁵ As set forth in Interpretation and Policy .04 to CBOE Rule 1.1, the term "Trust Issued Receipt" means a security (a) that is issued by a trust ("Trust") which holds specific securities deposited with the Trust; (b) that, when aggregated in some specified minimum number, may be surrendered to the Trust by the beneficial owner to receive the securities; and (c) that pays beneficial owners dividends and other distributions on the deposited securities, if any are declared and paid to the trustee by an issuer of the deposited securities. TIRs are listed on the CBOE pursuant to CBOE Rule 30.57.

¹⁶ See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002) (approving SR-Amex-2002-21).

¹⁷ See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan Katz, Secretary, Commission, dated July 11, 2002.

AMEX-2002-21, including both the ability to undertake limited side-by-side trading as well as limited integrated market-making, gives substantial competitive advantages to the Amex. Thus, in the interests of promoting a fair and competitive marketplace, the CBOE proposes to undertake integrated market making and side-by-side trading of ETFs and their related options to the same extent that the Commission has approved for the Amex.

Specifically, CBOE proposes to permit side-by-side trading and integrated market making of certain ETFs and TIRs and their related options, if the ETF or TIR meets the criteria set forth in Interpretation and Policy .03 to CBOE Rule 30.18.¹⁸ Specifically, CBOE proposes to permit DPMs and market makers in options on ETF shares and TIRs that meet the criteria set forth in the proposed new Interpretation and Policy .04 to CBOE Rule 30.18 to also act as the DPM and market makers, respectively, in the underlying securities without information barriers or physical barriers. CBOE also proposes new CBOE Rule 30.18A to require a DPM in options on an ETF or TIR that is also the DPM in the underlying security in a side-by-side environment to disclose on request to participants in the ETF, TIR, and option trading crowds information about aggregate buying and selling interest at different price points represented by limit orders on the ETF, TIR or option held by the DPM.

The CBOE notes that it remains concerned about the potential impact of any further expansion of side-by-side trading. While the Commission's approval of SR-Amex-2002-21 compels the CBOE to make this proposed rule change for competitive reasons, CBOE represents that this proposal seeks no more side-by-side trading than what the Commission has approved for the Amex in SR-Amex-2002-21.

¹⁸ The criteria for ETFs and TIRs set forth in the proposed Interpretation and Policy .03 to Rule 30.18 to qualify particular ETFs and TIRs for side-by-side trading and integrated market making are as follows:

(a) Component securities that in the aggregate account for at least 90% of the weight of the portfolio must have a minimum market value of at least \$75 million.

(b) The component securities representing 90% of the weight of the portfolio each have a minimum monthly trading volume during each of the last six months of at least 250,000 shares.

(c) The most heavily weighted component security cannot exceed 25% of the weight of the portfolio and the five most heavily weighted component securities cannot exceed 65% of the weight of the portfolio.

(d) The underlying portfolio must include a minimum of 13 securities.

All securities in the portfolio must be listed on a national securities exchange or the NASDAQ Stock Market.

⁷ See Securities Exchange Act Release No. 26147 (October 3, 1988), 53 FR 39556.

⁸ See Securities Exchange Act Release No. 28556 (October 19, 1990), 55 FR 43233 (October 26, 1990) (approving SR-CBOE-90-08).

⁹ 15 U.S.C. 78s.

¹⁰ See *id.* at 16 and nn. 30-31 (citing letter from Robert Ackerman, Vice President, CBOE, to Howard Kramer, Assistant Director, Division, Commission, dated October 15, 1990).

¹¹ See Securities Exchange Act Release No. 30068 (December 12, 1991), 56 FR 65764 (December 18, 1991) (approving File No. SR-CBOE-91-45).

¹² As set forth in Interpretation .02 to CBOE Rule 1.1, the term index portfolio receipts or "IPRs" means securities that (a) represent an interest in a unit investment trust ("Trust") which holds the securities that comprise an index on which a series of IPRs is based; (b) are issued by the Trust in a specified aggregate minimum number in return for a "Portfolio Deposit" consisting of specified numbers of shares of stock plus a cash amount; (c) when aggregated in the same specified minimum number, may be redeemed from the Trust which