

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 immediately upon receipt on the floor of the Exchange.<sup>6</sup>

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 is input electronically into the Exchange's systems immediately upon receipt on the Exchange, it is systematized.

The Exchange believes that the systematization requirement may be fulfilled in practice in a number of ways. The key is that the order must be systematized when the order is routed to the floor for execution. For example, under the proposed rule change, an order would meet the requirements of the rule if a floor broker in the trading crowd received an order over the phone and at the same time had a person from his or her booth input the order electronically. The requirements of the rule also would be satisfied if someone from the upstairs trading desk called a floor broker in the trading crowd on the floor with an order, while a clerk at the upstairs trading desk was simultaneously sending the order to the floor electronically. While it is possible that the floor broker in each of these situations would receive and begin the representation of the order prior to the arrival of the electronic order, the order entered electronically would be entered and routed in a manner consistent with the record keeping obligations and the requirements of COATS.<sup>7</sup>

Currently, the deadline to implement Phase V of COATS is August 29, 2003.<sup>8</sup>

<sup>6</sup> 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 Commission.

<sup>7</sup> The Exchange recognizes the need for effective and proactive surveillance for activities such as trading ahead and front-running. It currently conducts automated 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, which are designed to address, among other things, trading ahead and front-running.

<sup>8</sup> On June 10, 2003, the Directors of the Commission's Division of Market Regulation, Office of Compliance Inspections and Examinations, and Division of Enforcement granted CBOE and the other floor-based options exchanges an extension of time until August 29, 2003, to implement Phase V of COATS.

The Exchange intends to make the proposed changes to CBOE Rule 6.24 effective not later than August 29, 2003, or such later date as authorized in writing by the Directors of the Commission's Division of Market Regulation, Division of Enforcement, and the Office of Compliance, Inspections and Examinations.

Under the proposed change to Interpretation and Policy .04, the Exchange proposes to exempt from the systematization requirement stop-limit orders as defined in CBOE Rule 6.53(c)(iv) until December 11, 2003, or such earlier time as the Exchange's order routing and execution systems (such as COMPASS, ORS, PAR) have the functionality to handle stop-limit orders. The Exchange represents that stop-limit orders as defined in CBOE Rule 6.53(c)(iv) represent a very small percentage of the types of orders sent to and executed on the Exchange. The Exchange has an active systems project that will provide the functionality to handle stop limit orders in its order routing and execution systems.<sup>9</sup>

The proposed rule change would also permit the Exchange to exempt from the systematization requirement non-multiply listed index option classes and other option classes traded exclusively on the Exchange other than equity option classes ("exempt classes"). For example, the Exchange could exempt from the systematization requirement the following option classes traded exclusively on the Exchange: the Standard & Poor's 100® index option class (OEX), the Standard & Poor's 100® index option class (SPX), options on the Dow Jones Industrial Average<sup>SM</sup> (DJX), and options on the Diamonds® (DIA). Equity option classes traded solely on the Exchange would not be exempted from the systematization requirement. Orders in exempt classes would be required to be in a legible written form approved by the Exchange. This proposed change is consistent with the current practice permitted under CBOE Rule 6.24.

The proposed rule change would also keep 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 provided that such

<sup>9</sup> In their June 10, 2003, letter to the Exchange, the Directors of the Commission's Division of Market Regulation, Office of Compliance Inspections and Examinations, and Division of Enforcement also granted CBOE an extension of time until December 11, 2003, so that CBOE can modify its order routing and execution systems such that they would have the functionality to handle stop-limit orders.

communications are immediately thereafter relayed in written form, except in certain classes exempted by the Exchange. The proposed rule change would require that such communications be relayed immediately in electronic form rather than written form, unless an option class is exempted from this requirement. Currently, as provided in Interpretation and Policy .02(b) of CBOE Rule 6.24, the Exchange exempts the OEX, SPX, and DJX option classes, which are non-multiply listed index option classes. The Exchange proposes to amend subparagraph (b) of Interpretation .02 to state it may exempt non-multiply listed index and other option classes traded exclusively on the Exchange other than equity option classes under this Interpretation. The Exchange will publish via regulatory circular those options classes that it has exempted under Interpretation .02.

Finally, the Exchange has added a new Interpretation and Policy .05 to CBOE Rule 6.24, which states that accommodation liquidations as defined in CBOE Rule 6.54 are exempted from the systematization requirement.

## 2. Statutory Basis

CBOE believes that the proposed rule change is consistent with section 6(b) of the Act<sup>10</sup> in general and furthers the objectives of Section 6(b)(5)<sup>11</sup> in particular in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest. 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 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.

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

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