

implementation of ROS.⁵ ROS is a system developed by CBOE to open an entire options class, all series, as a single event, based on a single underlying value.⁶ The ROS pilot program is due to expire on September 30, 2003.⁷

III. Discussion

After careful review, 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.⁸ In particular, the Commission believes that the proposed rule change is consistent with section 6(b)(5) of the Act,⁹ in that it is designed to promote just and equitable principles of trade, 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 Commission notes that ROS has successfully operated since 1999 and since that time, has facilitated expedited openings of options classes on CBOE.

In the Pilot Program Approval Order, the Commission required CBOE to satisfy three conditions prior to seeking permanent approval of the ROS pilot. The first condition required CBOE to develop standards to ensure that market makers satisfy their obligation to price options fairly and to surveil for such compliance. In the Pilot Program Approval Order, the Commission recognized that certain aspects of ROS may require heightened scrutiny by the CBOE to ensure that market-makers are not permitted to use the flexibility they have to set an opening price to the disadvantage of investors and other market participants. In particular, ROS provides market-makers discretion to set

certain thresholds and the AutoQuote¹⁰ value that drives the ROS algorithm. CBOE has represented that market makers generally have set the contract and delta thresholds at a level that ensures that an options class that has orders to trade will not auto-open, to avoid openings based on erroneous prints in the underlying security or delayed updates to bid/ask information on underlying securities. CBOE further represented that it was still able to open classes within seconds of the opening of the underlying class, because ROS can open classes very quickly even if they are not set to auto-open.¹¹

CBOE has also submitted surveillance procedures designed to ensure, among other things, that market-makers exercise their discretion to set certain AutoQuote values consistent with their obligation to price options fairly.¹² The Commission believes the surveillance procedures submitted by the CBOE are reasonably designed to ensure that market makers do not abuse their discretion when setting AutoQuote values in setting the ROS opening price. Furthermore, these surveillance procedures should allow CBOE to better monitor market maker adjustments to AutoQuote and enable CBOE to bring sanctions for violative conduct when appropriate. However, because CBOE market makers set the contract and delta thresholds at levels that ensure that an options class that has orders to trade will not auto-open, giving CBOE market makers an opportunity to adjust AutoQuote at most openings, the Commission expects CBOE to aggressively surveil to ensure that market makers properly adjust AutoQuote values. The Commission also expects the Exchange to assess its surveillance procedures from time to time to determine whether they are adequate to ensure that market makers do not engage in manipulative or improper trading practices. Further, the Commission expects CBOE to consider whether any additional surveillance procedures are necessary to prevent manipulative or other improper practices.

The second condition required CBOE to develop a workable plan for the electronic incorporation of non-

bookable orders in ROS. On CBOE, non-bookable orders include broker-dealer and customer contingency orders. CBOE stated that few, if any, non-bookable orders are present at the open and that, based in its observations, firms consistently wait until after the ROS opening has been completed to represent non-bookable orders.¹³ CBOE has developed a procedure, albeit not an electronic one, for including non-bookable orders into the opening process. This procedure has been incorporated into CBOE Rule 6.2A and has been detailed in two regulatory circulars.¹⁴ CBOE argues a systems change to electronically incorporate non-bookable order in the ROS opening would have very little impact on ROS trading due to the few non-bookable orders present before the open.¹⁵ Furthermore, Phase V of the Consolidated Options Audit Trail ("COATS") Plan would require that all non-electronic orders be captured electronically for audit trail purposes.¹⁶ CBOE represents that this will facilitate its Regulatory staff's ability to investigate with more speed and efficiency any complaint regarding the execution received by a non-bookable order on the opening, in that the Exchange will now have an electronic record of the time of receipt of the order, in addition to the order information and the execution price of the order.¹⁷ The Commission has determined at this time to waive the requirement that CBOE develop a workable plan for the electronic incorporation of non-bookable orders in ROS based on the limited number of non-bookable orders that are present at the open and CBOE's ability to record information on non-bookable orders in COATS. The Commission also expects that CBOE will use COATS to respond to complaints about non-bookable orders, as well as to actively monitor the quality of executions received by non-bookable orders. The Commission also expects CBOE to continue to explore methods to electronically incorporate non-bookable orders in the event that non-bookable

⁵ See Securities Exchange Act Release No. 41033 (February 9, 1999), 64 FR 8156 (February 18, 1999) ("Pilot Program Approval Order"). ROS is governed by CBOE Rule 6.2A. CBOE Rules 6.2, 6.45, and 8.60 also reference ROS.

⁶ For a detailed description of how ROS operates, see Pilot Program Approval Order, *supra* note 5.

⁷ The Commission has extended the ROS pilot program five times. See Securities Exchange Act Release Nos. 42596 (March 30, 2000), 65 FR 18397 (April 7, 2000) (extending the pilot program until September 30, 2000); 43395 (September 29, 2000), 65 FR 60706 (October 12, 2000) (extending the pilot program until September 30, 2001); 44891 (October 1, 2001), 66 FR 51483 (October 9, 2001) (extending the pilot program until September 30, 2002); 46572 (September 30, 2002), 67 FR 62508 (October 7, 2002) (extending the pilot program until March 31, 2003); and 47573 (March 26, 2003), 68 FR 15780 (April 1, 2003) (extending the pilot program until September 30, 2003).

⁸ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ Under Interpretation .02 to CBOE Rule 6.2A, the term "AutoQuote" means either the Exchange's AutoQuote system or a proprietary autoquote system operated by a member of the trading crowd where the particular ROS class is traded.

¹¹ See ROS Notice, *supra* note 4.

¹² See letter from Jaime Galvan, Attorney II, Legal Division, CBOE, to Terri Evans, Assistant Director, Division of Market Regulation, dated August 13, 2003. CBOE requested confidential treatment for these surveillance procedures pursuant to 17 CFR 200.83.

¹³ See ROS Notice, *supra* note 4.

¹⁴ See CBOE Rule 6.2A(ii), and Regulatory Circulars RG99-35 (February 10, 1999) and RG00-40 (March 13, 2000).

¹⁵ See ROS Notice, *supra* note 4.

¹⁶ The COATS Plan is a plan that the options exchanges are required to submit to the Commission in order to comply with Section IV.B.e. of the 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 In the Matter of Certain Activities of Options Exchanges, Securities Exchange Act Release No. 43268, September 11, 2000; Administrative Proceeding File No. 3-10282.

¹⁷ See Amendment No. 1, *supra* note 3.