

November 16, 1994.<sup>3</sup> No comments were received on the proposal.<sup>4</sup>

## II. Description of the Proposal

CBOE Rule 15.10 concerns the availability to Exchange market makers of the bid test exemption from the National Association of Securities Dealers' ("NASD") short sale rule.<sup>5</sup> The Exchange is amending Rule 15.10 to expand the definition of "designated Nasdaq/NM security"<sup>6</sup> to include all Nasdaq/NM securities which underlie the options classes for which a market maker holds an appointment. Currently, the rule limits designated Nasdaq/NM securities to no more than three trading stations of a market maker, although CBOE Rule 8.3 allows market makers to have appointments, absent an exemption, in up to five trading stations. The CBOE believes the limitation to three trading stations is unnecessarily restrictive and that the proposed change is consistent with the application of the exemption for options market makers on other exchanges.<sup>7</sup>

The CBOE also is proposing to amend Interpretation .02 to CBOE Rule 15.10 to permit an options market maker, with prior notice to an Exchange Floor Official or Order Book Official, to facilitate an off-floor options or combination order and contemporaneously hedge the resulting options position with a short sale in applicable Nasdaq/NM securities as if such securities were designated securities under paragraph (c)(2) of the Rule. The Floor Official or Order Book official notified of such a transaction is required to file a report describing it

with the Department of Market Surveillance, and must give a copy of the report to the market maker.

Finally, the CBOE is proposing to amend Interpretation .03 to CBOE Rule 15.10 to allow a nominee of a market maker organization to effect bid test exempt short sales in a Nasdaq/NM security which the market maker nominee has not designated as qualifying for the exemption contained in paragraph (c)(2), provided that the security is a designated Nasdaq/NM security for another nominee of the market maker organization and such other nominee is not also present or represented by a Floor Broker in the applicable trading station at the time of the bid test exempt sale. The CBOE believes that this will allow a market maker organization to manage its obligations better when nominees are absent from the trading floor for reasons such as illness.

## III. Discussion

The Commission finds the proposed rule change consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act, because the proposal is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and protect investors and the public interest.

The Commission believes that the CBOE's proposal to expand the definition of "designated Nasdaq/NM security" is consistent with the market maker exemption from the NASD's bid test rule. This exemption recognizes the need for options market makers to hedge their options positions by buying or selling (including selling short) shares of underlying stocks or certain underlying component stocks contained in stock indexes. In relevant part, the NASD's market maker bid test exemption provides that a "qualified options market maker" is an options market maker who has received an appointment as a "qualified options market maker" for certain classes of stock options on Nasdaq/NM securities and indexes pursuant to the rules of a "qualified options exchange."<sup>8</sup> The exemption further provides that a "qualified options exchange" is a national securities exchange that has approved rules and procedures providing for designating market makers as qualified options market makers that

are designed to identify options market makers who regularly engage in market making activities in the particular options classes.<sup>9</sup>

The CBOE's proposal would expand the classes of stock options for which its market makers may be deemed "qualified options market makers" by extending the definition of "designated Nasdaq/NM security" to all Nasdaq/NM securities underlying options for which a market maker holds an appointment.<sup>10</sup> The new provision is consistent with the comparable provisions adopted by other options exchanges.<sup>11</sup>

The CBOE's proposal also is consistent with NASD Rules given that the exemption's availability is limited to securities underlying options contracts in which a market maker holds an appointment. A market maker has a continuous obligation to maintain a fair and orderly market with respect to such securities, and must conduct a certain percentage of trading on the CBOE in the appointed classes.<sup>12</sup> Additionally, the CBOE requires that to qualify for the market maker short sale exemption, a short sale in a Nasdaq/NM security must be effected to hedge, and in fact services to hedge, an options transaction.<sup>13</sup> The CBOE has adopted surveillance procedures designed to monitor its market makers' use of the market maker exemption so as to ensure that short sales effected by qualified options market makers are exempt hedge transactions and that other, nonqualified market makers, are not using the exemption.<sup>14</sup>

Proposed Interpretation .02 will allow an options market maker, with prior notice to a Floor Official or Order Book Official, to facilitate an off-floor order, and contemporaneously hedge the

<sup>3</sup> See Securities Exchange Act Release No. 34947 (November 7, 1994), 59 FR 59262.

<sup>4</sup> The CBOE filed its proposal after receiving a comment letter concerning its Rule 15.10. See letter from Michael J. Carusillo, General Partner, O'Connor & Associates, to Jeff Schroer, Vice President, Market Surveillance, CBOE, dated September 21, 1994 ("O'Connor Letter").

<sup>5</sup> The Commission approved the NASD's bid test (or "short sale") rule in Securities Exchange Act Release No. 34277 (June 6, 1994), 59 FR 34885 (amending the NASD's Rules of Fair Practice ("NASD Rules"). The CBOE's proposal concerning the market maker exemption from the bid test rule, along with the proposals of the other options exchanges, was approved in Securities Exchange Act Release No. 34632 (September 2, 1994), 59 FR 46999 (approving proposals by the American Stock Exchange ("Amex"), CBOE, New York Stock Exchange ("NYSE"), Pacific Stock Exchange ("PSE"), and Philadelphia Stock Exchange ("Phlx").

<sup>6</sup> CBOE Rule 15.10(c)(2)(ii)(B).

<sup>7</sup> See O'Connor Letter, *supra* note 4.

The O'Connor Letter compares the application of the CBOE's rule to the application of the corresponding rules of the other options exchanges concerning the market maker exemption to the NASD short sale rule. It concludes that the CBOE's rule is more restrictive, causing CBOE market makers to be placed at a disadvantage relative to market makers at other exchanges. *Id.*

<sup>9</sup> NASD Rules, Art. III, section 48(h)(2)(c).

<sup>10</sup> As noted above, CBOE Rule 8.3(c) provides that a market maker's appointment is limited to the options classes trading at no more than five trading stations absent an exemption by the Market Performance Committee. The Exchange recently filed a proposal (File No. SR-CBOE-94-44) to expand market maker appointments from five trading stations to 10, stating that the current five station limit puts it at a competitive disadvantage relative to other options exchanges. See Securities Exchange Act Release No. 35192 (January 4, 1995), 60 FR 3012.

<sup>11</sup> See Amex Rule 957(d)(2)(b)(i); NYSE Rule 959A(a); PSE Rule 4.19(c)(2)(B) (these exchanges allow the short sale exemption to be available to all Nasdaq/NM securities which underlie the options classes for which a market maker holds an appointment); Phlx Rule 1072(c)(2)(ii) (the Phlx limits the short sale exemption to Nasdaq/NM securities underlying no more than 20 options allocated or assigned).

<sup>12</sup> See CBOE Rule 8.7, Obligations of Market-Makers (setting forth specific obligations of market makers).

<sup>13</sup> CBOE Rule 15.10(c)(2)(ii).

<sup>14</sup> See Securities Exchange Act Release No. 34632, *supra* note 4.

<sup>8</sup> NASD Rules, Art. III, section 20(h)(2)(b).