

of each of the Acquired Funds, each Acquired Fund may be deemed an affiliated person of an affiliated person of the other Acquired Fund, and the Acquiring Fund. Because of this ownership, each Acquired Fund may be deemed an affiliated person of an affiliated person of the Acquiring Fund for reasons other than having a common investment adviser.

4. Section 17(b) of the Act provides that the Commission may exempt a transaction from the provisions of section 17(a) if the evidence establishes that the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair and do not involve overreaching on the part of any person concerned, and that the proposed transaction is consistent with the policy of each registered investment company concerned and with the general purposes of the Act.

5. Applicants request an order under section 17(b) of the Act exempting them from section 17(a) of the Act to the extent necessary to permit applicants to consummate the Reorganization. Applicants submit that the Reorganization satisfies the standards of section 17(b) of the Act. Applicants state that the Board has found that participation in the Reorganization is in the best interests of each Fund, and that the interests of the existing shareholders will not be diluted as a result of the Reorganization. In addition, applicants state that the exchange of Acquired Funds' shares for Acquiring Fund shares will take place on the basis of net asset value.

For the Commission, by the Division of Investment Management, under delegated authority.

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41821; File No. SR-CBOE-99-17]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to the Operation of the Retail Automatic Execution System

September 1, 1999.

I. Introduction

On April 16, 1999, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending the CBOE's rules governing the operation of its Retail Automatic Execution System ("RAES"). The proposal increases the maximum order sizes of certain RAES-eligible options and authorizes the appropriate Floor Procedure Committees ("FPCs") of the Exchange to change current procedures governing assignment and price improvement of RAES orders. On May 21, 1999, the CBOE filed with the Commission Amendment No. 1 to the proposal.³ Notice of the proposal was published in the **Federal Register** on June 17, 1999.⁴ The Commission received no comments on the proposal. On August 23, 1999, the CBOE filed Amendment No. 2 to the proposal,⁵ on August 31, 1999, the CBOE filed Amendment No. 3 to the proposal.⁶

II. Description of the Proposal

a. Summary

This filing does four things. First, it increases from 20 to 50 contracts the maximum size of orders for equity

options and certain classes of index options eligible to be executed through RAES.⁷ Second, it authorizes the appropriate FPCs to implement a new RAES order assignment procedure called "Variable RAES" (described below) for some or all classes of CBOE options. Third, it allows the appropriate FPCs to authorize automatic RAES "step-ups" for price differentials greater than the one "tick" differential currently specified in the rules.⁸ Fourth, it makes editorial revisions to clarify or update current RAES rules.

b. Previous Partial Approval

The Commission previously granted accelerated approval to a portion of this rule filing. Specifically, on August 23, 1999, the Commission approved Amendment No. 2, which permitted the CBOE to immediately implement Variable RAES in five stocks that are dually listed on both the Philadelphia stock Exchange ("Phlx") and the CBOE.⁹ Amendment No. 2 was filed in tandem with a related rule proposal, SR-CBOE-99-47, which increased the maximum RAES order size from 20 to 50 contracts in options on those five stocks only.¹⁰ SR-CBOE-99-47 became effective on August 23, 1999. The Commission granted immediate approval of Amendment No. 2 to enable Variable RAES to be used on August 23, when the new order size maximum on the five dually traded options went into effect.

c. Order Size Increase

Formerly, the maximum size of RAES-eligible orders was 20 contracts for all classes of equity options (other than the five dually traded classes noted above), all classes of sector index options and all other classes of index options (except options on the S&P 500 Index, the Nasdaq 100 Index, the Dow Jones Industrial Average, and interest rate options).¹¹ This proposed rule change

⁷ The proposal also effects a minor increase (from 99 contracts to 100 contracts) in the maximum size of RAES orders for options on two indices—the S&P 500 Index and the Nasdaq 100 Index—to bring those size maximums into conformity with size maximums for other index options and interest rate options. See *infra* note 11.

⁸ "Step-ups" refers to the ability to improve the price at which an order is executed on RAES to match a better price in another market.

⁹ Those stocks are Dell Computer Corporation ("DLQ"), International Business Machines ("IBM"), Johnson & Johnson ("JNJ"), Coca-Cola ("KO"), and Ford Motor Company ("F"). Securities Exchange Act Release No. 41782 (August 23, 1999), 64 FR 47881 (September 1, 1999).

¹⁰ Securities Exchange Act Release No. 41823 (September 1, 1999).

¹¹ The RAES eligibility maximum was formerly 99 contracts for options on the S&P 500 Index and the Nasdaq 100 Index, and 100 contracts for options on the DJIA and interest rate options. To simplify

Continued

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, the CBOE clarified issues relating to implementation of the new RAES order assignment procedures. See letter from Timothy Thompson, Director, Regulatory Affairs, CBOE, to Gordon Fuller, Special Counsel, Division of Market Regulation, SEC, dated May 20, 1999.

⁴ See Securities Exchange Act Release No. 41501 (June 9, 1999), 64 FR 32568.

⁵ Amendment No. 2 is described below. See letter from Christopher R. Hill, Attorney, CBOE, to Michael Walinskas, Associate Director, Division of Market Regulation, SEC, dated August 23, 1999.

⁶ Amendment No. 3 is described below. See letter from Timothy Thompson, Director, Regulatory Affairs, CBOE, to Gordon Fuller, Special Counsel, Division of Market Regulation, SEC, dated August 31, 1999.

increases the maximum order size for these options classes to 50 contracts. Increasing the RAES eligibility maximum to 50 contracts for these classes of options does not, however, automatically permit orders up to this size to be entered into RAES. Instead, the actual maximum RAES eligibility size will be established by the appropriate FPC of the CBOE, which may maintain the maximum for particular classes at levels below the 50-contract maximum.

Under existing Interpretation and Policy .01 under Rule 6.8, the appropriate FPC may increase the size of RAES-eligible orders for multiply-traded equity options to match the size of orders in options of the same class that are eligible for entry into the automated execution system of any other options exchange, subject to filing notice of the increase under Section 19(b)(3)(A) of the Act.¹² The CBOE nonetheless believes the FPC should be able to permit up to 50 contracts to be eligible for RAES in response to the perceived needs of the market without regard to automatic execution limits on other exchanges. The CBOE also seeks greater flexibility in competing for order flow with other exchanges that have 50-contract maximum eligibility levels for their own automatic execution systems, since the CBOE will not be limited to responding to increases in automatic execution eligibility levels initiated by the other exchanges. CBOE represents that its systems capacity is sufficient to accommodate the increased number of automatic executions anticipated to result from implementation of the proposal.

d. Variable RAES

The proposed rule change authorizes the appropriate FPCs to implement Variable RAES for some or all classes of CBOE options. Under former procedures, RAES orders were randomly assigned to market makers, and each market maker had to buy or sell the entire order assigned to him or her. By contrast, Variable RAES will enable each market maker to designate a maximum number of contracts he or she is willing to buy or sell when a RAES order is assigned to that market maker. No market maker, however, will

the administration of RAES and eliminate confusion, this proposal makes the RAES eligibility maximums 100 contracts for these four classes of options. See Rule 6.8(e). One hundred contracts is also the RAES eligibility maximum for options on the Dow Jones High Yield Select 10 Index. See Securities Exchange Act Release No. 41509 (June 10, 1999), 64 FR 32906 (June 18, 1999) (approving increase in RAES order size limit from 20 contracts to 100 contracts).

¹² 15 U.S.C. 78s(b)(3)(A).

be able to designate a maximum that is less than a stated minimum number of contracts per assignment established by the appropriate FPC. In determining appropriate minimum execution levels, the FPC must take into account whether market makers have sufficient capital to fill an order that size.

If the number of contracts in a RAES order is less than or equal to the market maker's specified limit, the market maker will be obligated to buy or sell all of the contracts in the order, and the next RAES order will be assigned to the next market maker on the RAES assignment rotation. If the number of contracts in an order exceeds the specified limit, the market maker will be obligated to buy or sell the number of contracts equal to the specified limit. The remainder of the order will be assigned to the next market maker on the RAES assignment rotation, who will likewise be obligated to buy or sell the number of remaining unassigned contracts in the order up to that market maker's limit. The assignment rotation will continue in this manner until all of the contracts in the order have been assigned to one or more market makers, even if this requires more than one assignment to the same market maker as the assignment rotation continues.

Variable RAES will apply to all classes of options eligible for entry into RAES. CBOE represents that Variable RAES will be implemented following the effectiveness of this proposed rule change, and will be described in a circular to be distributed to the membership prior to that time. If the appropriate FPC decides to implement a different RAES order assignment procedure, CBOE will file a proposed rule change with the Commission pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder.

e. Increase in Automation Step-Up Increment

Finally, the proposed rule change authorizes the appropriate FPC to establish a "step-up amount" for purposes of the automatic step-up procedure of Interpretation and Policy .02 under Rule 6.8 that is greater than the minimum quote interval ("tick") for that class of option under rule 6.42. The automatic step-up procedure formerly stated that in designated classes of multiple-traded options, if the Exchange's best bid or offer is inferior to the bid or offer in another market by no more than one tick, an order in RAES will be automatically excluded at the better bid or offer. The proposal enables the appropriate FPC to establish price differentials greater than one tick at which orders will be automatically

executed in RAES in order to match better bids or offers in other markets.

f. Amendment No. 3

Amendment No. 3 changes the language of the RAES rules to more clearly define the limits of the FPC's discretion to implement Variable RAES and increase automatic step-up increments. Amendment No. 3 also clarifies language in the RAES rules. Specifically, Amendment No. 3:

(1) Requires the appropriate FPCs to provide at least three days' advance notice to Exchange members of the FPC's intention to discuss an issue relating to the RAES allocation method, and to provide members with the opportunity to give written comments, or appear at the meeting, or both. To prevent delay the FPCs may initially implement Variable RAES without notice and comment; however, that initial implementation will be subject to review at the next FPC meeting, pursuant to notice and comment procedures;

(2) Describes the criteria the FPCs will consider in setting a minimum contract limit under Variable RAES. The Amendment explains that the appropriate FPC will select a minimum that is not so high as to discourage market makers from participating on RAES. On the other hand, the appropriate FPC will choose a level high enough that the market-makers retain the incentive to pay attention to and update their quotes;

(3) Clarifies language that orders routed over RAES "may be subject to such contingencies as the appropriate [FPC] shall approve." The Amendment revises this language to make clear that the FPC may approve certain "contingency orders" for routing to RAES. The FPC may consider whether the order can be easily accommodated by RAES without substantial system changes, whether the nature of the contingency makes it reasonable to include the order in RAES, and whether there is customer interest in including the order in RAES;

(4) Clarifies the term "group" in revised Interpretation .04 to Rule 6.8 which states that "that first order in any group of rerouted orders" will be entitled to be filled at the offer (bid) which existed at the time of the order's entry into the RAES system. The Amendment states that "group" refers to orders kicked out as the result of an instance where the prevailing market bid or offer is equal to the best bid or offer on the Exchange's book. When the market bid or offer changes or the booked order is traded such that the market no longer equals the book, then the instance by which an order will be kicked out in a particular group will have ended; and

(5) Describes the factors that would be considered by the appropriate FPC in determining whether to increase the "step-up" amount beyond the minimum increment for the particular class of options. RAES will execute orders in designated classes at the National Best Bid or Offer ("NBBO") if the NBBO is better than the CBOE's best bid or offer by no more than the "step-up amount." In determining the "step-up amount," the

appropriate FPC will consider the impact of such decision in attracting order flow to the Exchange, the desire or need to reduce the amount of orders rejected for manual handling to provide for a more orderly market, and any other relevant factors.

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.¹³ 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, the requirements of Section 6 of the Act.¹⁴ Section 6(b)(5)¹⁵ of the Act that the rules of an exchange must be designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating securities transactions. These rules also must help to remove impediments to and perfect the mechanism of a free and open market.

Moreover, the Commission finds good cause for approving Amendment No. 3 prior to the 30th day after the date the Amendment is published for comment in the **Federal Register** pursuant to Section 19(b)(2) of the Act.¹⁶ Amendment No. 3 addresses the discretion of the FPCs to implement Variable RAES and expand the automatic step-up increment, but does not otherwise affect the operation of RAES. In view of the immediate need of RAES market makers to limit their risk to compensate for increased exposure to the larger RAES order sizes, the Commission finds that acceleration of Amendment No. 3 is appropriate.

The Commission does not object at this time to extending the benefits available through RAES to larger-size customer orders up to 50 contracts. The Commission believes that increasing to 50 the number of option contracts executable through RAES will enable the Exchange to more effectively and efficiently manage increased order flow in actively traded option classes consistent with its obligations under the Act. In addition, this increase should bring the speed and efficiency of automated execution to a greater number of retail orders. The Commission also believes that the CBOE

should have flexibility to compete for order flow with other exchanges without being limited to responding to increases in automatic execution eligibility levels initiated by those other exchanges. The Commission notes that it has approved similar proposals by other exchanges increasing to fifty the maximum size of orders that may be executed automatically.¹⁷

The Commission believes, based on representations by the Exchange, that the increase will not expose RAES to risk of failure or operational breakdown. Our approval of this increase is expressly conditioned on CBOE's representation that its systems capacity is sufficient to accommodate the increased number of automatic executions anticipated to result from implementation of this proposal.

Although the Commission has a degree of comfort with respect to the proposed increase, the Commission notes that any proposed increases above fifty contracts may raise additional issues, including such matters as market maker financial exposure, price improvement, and quote dissemination. Because of these concerns, the Commission welcomes the opportunity to review the Exchange's experience with any increase in maximum order size to fifty contracts. If, in the future, exchanges seek to increase order size levels above fifty contracts, this examination will help the Commission assess whether such increases are appropriate and, if so, whether the Commission should seek additional assurances regarding such increases.

In addition, the Commission is persuaded that permitting the CBOE to implement Variable RAES is appropriate. Variable RAES allows RAES market makers to choose the level of risk they are comfortable with (subject to minimum size requirements set by the (FPCs). Allowing market makers to limit their risk in this way is particularly important because the CBOE may increase the maximum size of orders eligible for RAES from 20 to 50 contracts in many options classes, thus increasing the potential exposure of RAES market makers to risk in those options. In approving Variable RAES, however, the Commission emphasizes that its approval is expressly conditioned on the CBOE's representation that the FPCs will take market maker capitalization into account in setting the RAES order size minimums, thus further reducing the

risk market makers and exposed to. Accordingly, the Commission finds that increasing the maximum size of RAES orders, in conjunction with implementation of Variable RAES, will serve to remove impediments to a free and open market while fostering investor protection, consistent with section 6(b)(5) of the Act.

Finally, the Commission finds that allowing the FPCs to expand the step-up limit beyond one tick for multiply traded options removes impediments to a free and open market and protects investors consistent with Section 6(b)(5) of the Act, by increasing the likelihood that RAES investors will gain to superior bids and offers available in another market.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether it is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the Amendment that are filed with the Commission, and all written communications relating to the Amendment between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-99-17 and should be submitted by October 7, 1999.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-CBOE-99-17) be, and hereby is, approved; and that Amendment No. 3 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,
Deputy Secretary.

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¹³ The Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹⁴ 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ See Securities Exchange Act Release No. 36601 (December 18, 1995), 60 FR 66817 (December 26, 1995); see also Securities Exchange Act Release No. 41823 (September 1, 1999) (SR-PCS-99-04).

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).