SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50028; File No. SR-CBOE-2004-16)

July 15, 2004

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to a Proposed Rule Change and Amendment No. 1 Thereto Relating to an Interpretation of Paragraph (b) of Article Fifth of its Certificate of Incorporation and an Amendment to Rule 3.16(b)

I. Introduction

On March 4, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), 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 to adopt an interpretation, embodied in an agreement dated December 17, 2003 ("2003 Agreement"), between the CBOE and the Board of Trade of the City of Chicago, Inc. ("CBOT"), of paragraph (b) of Article Fifth of the CBOE Certificate of Incorporation ("Article Fifth(b)") and CBOE Rule 3.16, pertaining to the right of the 1,402 Full Members of CBOT to become members of CBOE without having to purchase a CBOE membership ("Exercise Right"). On April 9, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.[3] The proposed rule change, as amended, was published for comment in the Federal Register on May 3, 2004.[4] The Commission received one comment letter on the proposed rule change.[5] On May 25,

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See letter from Arthur B. Reinstein, Deputy General Counsel, CBOE, to Lisa N. Jones, Special Counsel, Division of Market Regulation ("Division"), Commission, dated April 8, 2004 ("Amendment No. 1").

4 Securities Exchange Act Release No. 49620 (April 26, 2004), 69 FR 24205.

5 Letter from Thomas A. Bond, Member, CBOE, et al., to Jonathan G. Katz, Secretary, Commission, dated April 28, 2004.

2004, the CBOE submitted a response to the comment letter,[6] and the commenter replied to CBOE's response in a second comment letter submitted on June 16, 2004.[7] This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

The CBOE is proposing to interpret Article Fifth(b) to explain how it will apply, upon the distribution by the CBOT to each of its 1,402 Full Members upon their individual request, to a separately transferable interest representing the Exercise Right component of each CBOT Full Membership. According to the CBOE, the CBOT's willingness to issue transferable Exercise Right interests is reflected in the 2003 Agreement. Because CBOE Rule 3.16 currently refers to certain terms that were previously interpreted and defined in an agreement between CBOE and the CBOT in 1992 ("1992 Agreement"), and the terms are now further interpreted and defined in the 2003 Agreement, the proposed rule change also amends CBOE Rule 3.16 to add a reference the 2003 Agreement.

The 2003 Agreement contemplates the issuance by the CBOT of a separately transferable interest representing the Exercise Right component of a CBOT Full Membership in advance of the consummation of the CBOT's proposed corporate restructuring, which contemplates a similar separately transferable interest structure.[8] In addition, the CBOE represents that the

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6 Letter from Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE, to Jonathan G. Katz, Secretary, Commission, dated May 24, 2003.

7 Letter from Thomas A. Bond, Member, CBOE, et al., to Jonathan G. Katz, Secretary, Commission, dated June 8, 2004 ("June 8th Letter").

8 The CBOE noted that the CBOT's proposed restructuring has not yet been consummated and that it remains uncertain when the proposed restructuring will occur. Indeed, the 2003 Agreement specifically states that the CBOT is not obligated to consummate the contemplated restructuring or any other restructuring. The CBOE also noted that the

CBOT's membership has approved changes to the CBOT Rules and Regulations, pursuant to the terms of the 2003 Agreement, to give effect to a structure providing for the issuance of these interests. Thus, the interpretation, embodied in the 2003 Agreement, constitutes the substance of the proposed rule change.

The interpretation of Article Fifth(b), embodied in the 2003 Agreement, includes definitions of who will be "Eligible CBOT Full Members" and "Eligible CBOT Full Member Delegates" entitled to exercise after the CBOT has issued separately transferable interests representing the Exercise Right component of CBOT Full Memberships to those CBOT Full Members who request them. The interests are referred to in the 2003 Agreement and in this filing as "Exercise Right Privileges."

The CBOE represents that, under these definitions, to become a member of the CBOE by virtue of the Exercise Right, the holder or delegate (i.e., a lessee under CBOT Rules and Regulations) of one of the 1,402 outstanding CBOT Full Memberships in which an Exercise Right Privilege has been issued must possess one Exercise Right Privilege, whether bundled or unbundled[9] from the related CBOT Full Membership. In addition, the CBOE believes that a CBOE exerciser member must also possess all of the other rights or privileges appurtenant to a CBOT Full Membership; meet the applicable membership and eligibility requirements of the

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CBOT's proposal to issue a separately transferable interest representing the Exercise Right as part of its restructuring was the subject of a prior proposed interpretation by the CBOE of Article Fifth(b), which was filed with the Commission as a proposed rule change in File No. SR-CBOE-2002-01. On April 7, 2004, the CBOE withdrew this filing. See letter from Arthur B. Reinstein, Deputy General Counsel, CBOE, to Lisa N. Jones, Special Counsel, Division, Commission, dated April 6, 2004.

[9] According to the CBOE, under the proposed interpretation of Article Fifth(b) embodied in the 2003 Agreement, Exercise Right Privileges may be separately bought and sold and bundled and rebundled with the other rights and privileges of CBOT Full Membership for purposes of making the holder of an Exercise Right Privilege eligible to exercise.

CBOT; and be deemed to be a "CBOT Full Member" or a "CBOT Full Member Delegate" under the CBOT Rules and Regulations.

The 2003 Agreement also provides that the CBOT will adopt and maintain rules and procedures acceptable to the CBOE governing the issuance and subsequent transfer of Exercise Right Privileges and CBOT Full Memberships, to enable the CBOE to administer the operation of the Exercise Right in a manner consistent with the interpretation embodied in the 2003 Agreement. In addition, the 2003 Agreement states that the CBOE intends to make an offer to CBOT Full Members that, subject to the terms and conditions of the offer, will allow the CBOE to purchase Exercise Right Privileges from those CBOT Full Members that accept the offer.[10] Further, as provided in the 2003 Agreement, the CBOT and the CBOE have each agreed to provide to the other certain current information regarding the status of their members, including exercisers and persons who own or lease an Exercise Right Privilege.

The CBOE represents that the proposed interpretation of Article Fifth(b) is consistent with the language of Article Fifth(b), and that the interpretation does not propose to amend Article Fifth(b) in any respect; it only interprets how Article Fifth(b) would apply in circumstances that were not envisioned when Article Fifth(b) was adopted, and therefore were not addressed in the language of Article Fifth(b).[11] The CBOE also believes that the proposed

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10 In addition, the 2003 Agreement states that CBOE's offer would have no effect on a CBOT Full Member's right to exercise on the CBOE if the CBOT Full Member chooses not to accept CBOE's offer, and that holders of the Exercise Right would continue to be entitled to become an exerciser member of the CBOE.

11 By its terms, Article Fifth(b) may be amended only with the approval of 80% of CBOE's members admitted by exercise, and 80% of CBOE's members admitted other than by exercise, each voting as a separate class.

interpretation of Article Fifth(b) is consistent with the interpretation of the Exercise Right embodied in the 1992 Agreement.[12]

Finally, the CBOE represents that the interpretation of Article Fifth(b), embodied in the 2003 Agreement, is intended to apply solely in the circumstances involving the issuance of Exercise Right Privileges to some or all of its 1,402 Full Members as described in the 2003 Agreement, so as to make it clear that the interpretation is not intended to cover any other circumstances that might arise and also have an impact on the Exercise Right.

III. Summary of Comments

As noted above, the Commission received comments on the proposed rule change[13] from several members of the CBOE.[14] In general, the commenters believe that the Commission should not approve the proposed rule change because the interpretation, embodied in the 2003 Agreement, constitutes an amendment to Article Fifth(b) and thus should be subject to a membership vote.[15] According to the commenters, Article Fifth(b) was established (and approved by the Commission) to provide a mechanism for CBOE members and CBOT members who exercise on the CBOE ("CBOE exerciser members") to: (1) decide on whether changes in

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12 The CBOE noted that the proposed interpretation of the Exercise Right that is the subject of this filing does not displace the interpretation embodied in the 1992 Agreement, except it provides that if there are any inconsistencies between the interpretation embodied in the 2003 Agreement and the interpretation embodied in the 1992 Agreement, then the interpretation embodied in the 2003 Agreement would control.

13 The Commission notes that the commenters refer to two separate proposed rule changes filed by the CBOE – File No. SR-CBOE-2002-01 and SR-CBOE-2004-16. But see supra note 8 (noting that CBOE has withdrawn File No. SR-CBOE-2002-01).

14 See supra notes 5 and 7.

15 See supra note 11.

the definition or structure of a CBOT member would affect the Exercise Right, and (2) protect one class of CBOE membership from adversely affecting the other.

Regarding CBOT's proposed restructuring, the commenters believe that the CBOT's proposed restructuring necessitates an amendment to Article Fifth(b), and not an interpretation, because once the CBOT demutualizes, it will no longer be a membership organization. In particular, the commenters state that, changing from a membership structure, in which CBOE and its members have information on actions of the CBOT that affect the Exercise Right and the number of CBOE exerciser members, to a demutualized stock corporation affects the governance and operations of the CBOT. The commenters also express concern that, along with CBOT's proposed restructuring, committee structures, petition processes, and representation on the board of directors would also change. Therefore, the commenters believe that the CBOT's restructuring warrants an Article Fifth(b) vote. The commenters further note that the definition of a "member of the Board of Trade" is being amended in the CBOT's proposed restructuring, which should be subject to an Article Fifth(b) vote. The commenters are also concerned that, if the CBOT demutualizes, the Exercise Right could be negated by the CBOE; they cite to a provision in the 1992 Agreement that states that, if the CBOT, among other things, is acquired by another entity (and the surviving entity is not a registered exchange), then Article Fifth(b) would not apply.

In response to the commenters' concerns, the Exchange maintains that the CBOT's issuance of the Exercise Right Privileges is separate and distinct from the CBOT's pending restructuring.[16] The Exchange believes that the commenters' concerns primarily refer to changes

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[16] In its June 8th Letter, the commenters replied that, although SR-CBOE-2002-01 was withdrawn, they believe that the CBOT restructuring will be occurring soon, and

in the structure or governance of the CBOT resulting from a demutualization -- a circumstance not subject to this filing. In addition, the Exchange notes that the proposed interpretation provides that, although the Exercise Right Privilege would be a transferable interest, the holder of the Exercise Right Privilege would not have the right to exercise on the CBOE unless the holder also possess a CBOT Full Membership.

The commenters also express concern that the proposed interpretation states that certain disputes concerning the definition of a CBOT member as it pertains to the Exercise Right will be subject to arbitration as opposed to the membership vote provided in Article Fifth(b). Further, the commenters believe that according to the 1992 Agreement, a CBOE exerciser member does not have the right to transfer (whether by sale, lease, gift, bequest, or otherwise) its CBOE regular membership or any other trading rights and privileges appurtenant thereto. The commenters interpret provisions of the 1992 Agreement to require that all equity and trading rights would have to be assembled to exercise if the CBOT's demutualization were to occur. Thus, the commenters are concerned that the proposed interpretation would allow the CBOT to demutualize into three classes of shares (A, B, and C) that can be split and sold separately, which constitutes an amendment to Article Fifth(b) and not an interpretation.[17]

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therefore the Commission should not separate the issues presented in both filings (citing to a letter from Charles P. Carey, Chairman, CBOT, which generally provides that, upon final court approval of a settlement agreement with plaintiffs in the minority member lawsuit, and the Commission declaring CBOT's registration statement effective, it can move forward with a membership vote and complete the restructuring). See supra note 7.

[17] The commenters also state that, under the CBOT's membership organization, the voting rights are joined with the trading rights and equity interests and are not separated. However, when CBOT is demutualized, the parts will be separated and consequently the parties holding the voting rights may be different and have different agendas than the parties having the trading rights.

In response to the commenter's concerns, the Exchange believes that the purpose of the Exercise Right Privilege is to create an interest that CBOE, or others, might purchase to reduce the number of outstanding Exercise Rights, and to give CBOT members a way to realize the value of the Exercise Right without having to sell their entire CBOT membership.[18] The Exchange believes that the proposed interpretation embodied in the 2003 Agreement is consistent with the language of Article Fifth(b) in that the Exercise Right would remain available to a person so long as he or she remains a member of the CBOT.[19] The Exchange notes that the 1992 Agreement provides that if a CBOT Full Membership is divided into separate parts, a person must hold all of the parts to exercise on the CBOE. The Exchange states that the interpretation does not amend Article Fifth(b), rather, as noted above, the interpretation describes how the Article would apply under circumstances that were not originally contemplated when Article Fifth(b) was adopted.

Further, the Exchange represents that it has been advised by its Delaware counsel that, under Delaware state law, it is within the general authority of CBOE's Board of Directors to interpret its governing documents when questions arise as to their application in these types of circumstances, so long as the interpretation adopted by the Exchange's Board of Directors is

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18 In response, commenters state that the proposed interpretation would create two classes of CBOT memberships—one with the Exercise Right and one without. Thus, CBOT members would be able to receive value for Exercise Right, which was not recognized in Article Fifth(b) and the 1992 Agreement. See supra note 7.

19 The CBOE represents that, if and when the CBOT restructures and is no longer a membership organization, the CBOE will further interpret the Exercise Right to determine its application in light of the demutualization. Telephone conversation between Arthur B. Reinstein, Deputy General Counsel, CBOE, and Lisa N. Jones, Special Counsel, Division, Commission, on June 10, 2004.

consistent with the terms of the governing documents themselves.[20] The Exchange represents that the interpretations do not constitute amendments to the governing documents, and thus are not subject to the procedures that would apply if they were actually being amended.[21]

IV. Discussion

After careful review of the proposal, the comments received, and CBOE's response to the comments, 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.[22] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[23] which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, and in general to protect investors and the public interest, and Section 6(c)(3)(A) of the Act,[24] which permits, among other things, an exchange to examine and verify the qualifications of an applicant to become a member, and the natural persons associated with such applicant, in accordance with the procedures established by exchange rules.

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20 See letter from Michael D. Allen, Esq., Richards, Layton & Finger, to Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE, dated June 29, 2004 (providing a legal opinion from Delaware counsel in connection with CBOE-2004-16) ("Opinion of Counsel").

21 In its June 8th Letter, the commenters reply that, although the CBOE Board of Directors has the right to interpret changes in the CBOT membership, Article Fifth(b) requires both the CBOE member and the Exercise Right holder to decide if changes or amendments to Article Fifth(b) are permissible. Thus, the commenters believe that the CBOE Board of Directors is usurping members' rights by interpreting Article Fifth(b). See supra note 7.

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

23 15 U.S.C. 78f(b)(5).

24 15 U.S.C. 78f(c)(3)(A).

The CBOE believes that the proposed interpretation should clarify a circumstance regarding the Exercise Right that was not originally envisioned by the CBOE and CBOT when Article Fifth(b) was adopted. The CBOE also represents that the CBOT will issue to each of its 1,402 Full Members, upon their individual request, a separately transferable interest representing the Exercise Right component of the CBOT Full Membership. Moreover, the CBOE represents that to be eligible as a CBOE exerciser member, one must hold a CBOT Full Membership, which would include one Exercise Right Privilege (representing the Exercise Right) in addition to all the other rights or privileges appurtenant to a CBOT Full Membership.

The Commission has considered the commenters' concerns about how the proposed interpretation could adversely affect the Exercise Right. In its decision to approve the proposal, the Commission is relying on CBOE's representation that the CBOT will adopt and maintain rules and procedures governing the issuance and transfer of the Exercise Right Privileges to enable the CBOE to administer the operation of the Exercise Right in a manner consistent with Exchange rules. Further, the Commission notes that CBOE has represented that both the CBOE and CBOT will provide each other with current information regarding the status of their members, including exerciser members and persons who own or lease an Exercise Right Privilege. The Commission believes that this open exchange of information regarding the Exercise Right should adequately address any concerns that the proposal will adversely affect CBOE regular membership, or any other trading rights and privileges thereof.

The Commission has also considered the commenters' concerns about the CBOT's proposed restructuring, and notes that CBOT's proposed restructuring has not yet been consummated. The Commission emphasizes that this order only approves CBOE's interpretation as it relates to the proposed changes to CBOE Rule 3.16. The Commission is not making a

finding on any facts and circumstances surrounding CBOT's proposed restructuring under Delaware law.

In addition, the Commission is not approving or disapproving the terms of the 2003 Agreement; rather, the Commission is approving a proposed rule change filed by the CBOE which interprets CBOE's rules. Further, in approving this proposal, the Commission is relying on CBOE's representation that its interpretation is appropriate under Delaware state law,[25] and CBOE's Opinion of Counsel that it is within the general authority of its Board of Directors to interpret Article Fifth(b) when questions arise as to its application under certain circumstances, so long as the interpretation adopted by the Exchange's Board of Directors is made in good faith, consistent with the terms of the governing documents themselves, and not for inequitable purposes.[26] The Commission has not independently evaluated the propriety of CBOE's interpretation under Delaware state law.

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25 Telephone conversation among Arthur B. Reinstein, Deputy General Counsel, CBOE, Katherine A. England, Assistant Director, and Lisa N. Jones, Special Counsel, Division, Commission, on July 15, 2004.

26 See supra note 20 at p.5.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[27] that the proposed rule change (SR-CBOE-2004-16), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[28]

Margaret H. McFarland
Deputy Secretary

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27 15 U.S.C. 78s(b)(2).

28 17 CFR 200.30-3(a)(12).