

The Commission believes that the proposed commentary to Rule 60 regarding the disclaimer for vendor liability will provide needed protection for both the Exchange and vendors that may be retained by the Exchange to provide various services for use by member firms. If the Exchange does not have the ability to negotiate such liability protection, it would become increasingly difficult to find vendors willing to provide the Exchange with the essential services that it needs.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (SR-Amex-96-10) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-37732; File No. SR-CBOE-96-29]

Self-Regulatory Organizations; Order Approving a Proposed Rule Change by the Chicago Board Options Exchange, Incorporated, Relating to the Exercise of American-style Index Options

September 26, 1996.

I. Introduction

On April 26, 1996, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed a proposed rule change with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² to adopt new CBOE Rule 24.18 which prohibits the exercise of an American-style index option series after the holder has entered into an offsetting closing sale (writing) transaction.

Notice of the proposal was published for comment and appeared in the Federal Register on August 15, 1996.³ No comment letters were received on the proposed rule change. This order approves the Exchange's proposal.

II. Description of the Proposal

As noted in CBOE's Regulatory Circular RG 96-11,⁴ the rules and procedures of The Options Clearing Corporation ("OCC") permit a holder of an American-style option⁵ to exercise that options at any time up to the exercise cut-off time on any day, other than the final trading day, even if the holder had entered into an offsetting closing sale transaction earlier that day. This result stems from the fact that on such days OCC processes opening purchase transactions and exercises before it processes closing sales transactions, so that option purchasers remain holders of their options on OCC's books for the purpose of exercise without regard to their closing sales that day.

The Exchange is concerned that this result may be confusing to investors—because it may give the appearance that investors are able to exercise the same options which they have previously sold—and lead to a perception that this result is unfair to writers of American-style index options that are in the money by subjecting them to a potentially increased "timing risk" of the type described under "Special Risks of Index Options" on pages 73-74 of the risk disclosure document entitled "Characteristics and Risks of Standardized Options" (February 1994).⁶

Additionally, the Exchange believes that the average retail customer might not understand how investors could exercise options which they believed they no longer owned. The Exchange represents that, during the period from November 1993, through December 1995, almost all of the gross exercises in customers' accounts were effected at one clearing firm on behalf of a single customer that is a foreign professional trading account. Accordingly, the Exchange believes that retail customers might view the gross exercise ability as giving professional traders an unfair advantage over retail customers and that such perception could lead to the diminished popularity of Standard and Poor's 100 ("OEX") index options for retail customers.⁷

⁴ See Securities Exchange Act Release No. 36797 (January 31, 1996), 61 FR 4691 (February 7, 1996) (File No. SR-CBOE-96-03).

⁵ An American-style option may be exercised at any time prior to expiration.

⁶ This document is generally known as the Options Disclosure Document or "ODD".

⁷ See Letter from Michael L. Meyer, Attorney, Schiff Hardin & Waite, to John Ayanian, Attorney, Office of Market Supervision ("OMS"), Division of Market Regulation ("Market Regulation"), Commission, dated June 17, 1996. OEX index options are the only American-style index options

To eliminate this possible perception of unfairness, the proposed rule would prohibit CBOE members from effecting an exercise of an OEX options series (or any other American-style index option series subsequently listed by the Exchange), whether on the member's own behalf or on behalf of a customer, if the member knew or had reason to know that the exercise was for more option contracts than the "net long position" of the account for which the exercise is to be made. For this purpose, the "net long position" in an account is the net position of the account in options of a given series at the opening of business of the day of exercise, plus the total number of such options purchased on that day in opening purchase transactions up to the time of exercise, less the total number of such options sold on that day in closing sale transactions up to the time of exercise.

In order to prevent persons from circumventing the proposed rule by designating a sale as "opening" so as to maintain a net long position capable of being exercised, and then redesignating the sale as "closing" by means of an adjustment later in the day if in fact the long position has not been exercised, the rule would prohibit a member from adjusting the designation of an opening transaction to a closing transaction except to remedy mistakes or errors made in good faith.

A market maker's transactions are not required to be marked as opening or closing. Rather, a market maker's purchase and sales transactions are netted by OCC every day after exercises are processed. As a result, it is impossible to tell whether a particular transaction by a market maker is intended as an opening or closing transaction. Under OCC's processing procedures, unmarked market makers' transactions are in effect treated as opening transactions prior to the processing of exercises and as closing transactions thereafter. For the purpose of applying the prohibition of the proposed rule, every market maker transaction would be treated as a closing transaction to the extent the market maker has pre-existing positions (including positions resulting from transactions effected earlier that day) which could be netted against the transaction. For example, if a market maker is long 10 option contracts of a series and sells 15 contracts of that series, the sale will be deemed, under the proposed rule, to be a closing sale transaction for 10 contracts and an

currently traded at the CBOE. All other CBOE index option are European-style, with exercise only permitted upon their expiration.

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 37540 (August 8, 1996), 61 FR 42455.

opening sale transaction for 5 contracts, resulting in a net short position of 5 contracts. If the market maker then purchases 20 contracts, the purchase will be deemed a closing purchase for 5 contracts and an opening purchase for 15 contracts, resulting in a net long position 15 contracts. Under the proposed rule, the market maker would be permitted to exercise only those 15 contracts. In the absence of the proposed rule, the market maker would have been able to exercise 30 contracts, representing his gross long position, before netting against this position the 15 contracts sold.

The Exchange notes that the proposed rule is not intended to affect OCC's processing rules and procedures. If a member submitted an exercise notice to OCC in violation of the proposed CBOE rule, the exercise would be processed by OCC in accordance with its procedures. In that case, the proposed CBOE rule would be enforced solely through the Exchange's disciplinary procedures.

The Exchange emphasizes that the proposed rule has been adopted to eliminate the perception that a holder's ability to exercise options that had been the subject of closing transactions might create enhanced risk to writers of OEX options. However, it is not clear that the writers of in-the-money OEX options will, in fact, be subject to less risk as the result of the proposed rule. Such writers should continue to anticipate that they could be assigned an exercise of their options positions, especially as expiration approaches. (For example, the proposed rule would not prohibit the exercise of an OEX option held in a net long position before—even seconds before—an opening sales transaction in that option has been effected.) It is possible that the early exercise of OEX options will continue at the same level after the proposed rule becomes effective as before.

Upon the effectiveness of the proposed rule, the Exchange would modify Regulatory Circular RG 96-11 to describe the proposed rule. Three examples were given in the Regulatory Circular as originally published on January 17, 1996. These three examples would be modified to read as follows (italicized language is proposed to be added; language in brackets is proposed to be deleted):

Example 1: Investor X is long 15 call option contracts of a series at the opening of a trading day other than the final trading day. During that day, X purchases 20 contracts of that series in opening purchase transactions and sells 10 contracts in closing sale transactions. X will be able *under OCC's rules* to exercise 35 contracts of that series that

day. *However, in the case of American-style index options only (i.e., OEX options), CBOE Rule 24.18 would prohibit a member who knows or has reason to know of the closing sale transactions from exercising on X's behalf more than the net long position of 25 contracts at any time at or after the closing sale of 10 contracts.*

Example 2: Investor Y is short 20 call option contracts of a series at the opening of such a trading day. During the day, Y purchases 20 contracts of that series in opening purchase transactions. Y will be able to exercise 20 contracts of that series that day, and will remain short the 20 contracts. *However, in the case of OEX option contracts, if Y's transactions had been effected in a market-maker's account, the purchase would have been deemed to have been a closing transaction for the purposes of CBOE Rule 24.18 and would have been offset by Y's short position, resulting in no net long position to exercise.*

Example 3: Market-maker Z is short 100 call options contracts at the opening of that trading day. During the day, Z purchases 100 contracts and sells 100 contracts of that series[, and Z does not mark the transactions as opening or closing]. Z will be able to exercise 100 contracts of that series that day *under OCC's rules. However, in the case of OEX option contracts, CBOE Rule 24.18 would prohibit Z from exercising any contracts without regard to the sale transactions, since the purchase transactions would be deemed to be closing transactions, and would be netted against his beginning short position, resulting in no net long position to exercises.*

III. Commission Finding and Conclusions

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(b)(5) of the Act.⁸ Specifically, the Commission finds that the Exchange's proposal strikes a reasonable balance between the Commission's mandates under Section 6(b)(5) to remove impediments to and perfect the mechanism of a free and open market and a national market system, while protecting investors and the public interest.

The Commission believes that it is reasonable for the Exchange to conclude that permitting holders of American-style index options series to exercise positions greater than their "net long"

position, as described above, may lead to a possible perception of unfairness to retail investors and American-style index option writers. Effectively, the proposal creates an option exercise restriction upon holders of American-style index options, preventing such holders from exercising positions in excess of their net long position. The Commission believes that the imposition of a restriction on exercise requires a careful balancing of the Exchange's need for such a restriction with the impact that such a restriction will impose upon options market participants, including market professionals and individual investors.

Based on representations of the Exchange, the Commission believes that the proposed limited restriction on exercise is reasonable and should not adversely impact (1) the options exercise practices of existing OEX options market participants, (2) market participants' ability to utilize the options markets, or (3) trading in American-style index options generally. Particularly, the Commission believes that the Exchange has reasonably balanced the impact of the proposed rule change on option holders with its desire to eliminate the possible perception of unfairness on behalf of retail customers and American-style index option writers.

The Commission expects the Exchange to promptly modify Regulatory Circular RG96-11 to describe the proposed rule and distribute the new circular to its membership. Moreover, the Commission notes that the CBOE has established surveillance guidelines that should help to ensure compliance with the new policy.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁹ that the proposed rule change (File No. SR-CBOE-96-29) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,
Deputy Secretary.

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Self-Regulatory Organizations; Proposed Rule Changes; Philadelphia Stock Exchange, Inc.

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Self-Regulatory Organizations;
Philadelphia Stock Exchange, Inc.; Order

⁹ 15 U.S.C. 78s(b)(2).

¹⁰ 17 CFR 200.30-3(a)(12).

⁸ 15 U.S.C. 78f(b)(5).