SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42223; File No. SR–Amex–99–40; SR–PCX–99–41; SR–CBOE–99–59]

Self-Regulatory Organizations; American Stock Exchange LLC; Pacific Exchange, Inc.; Chicago Board Options Exchange, Inc.; Order Granting Accelerated Approval to Proposed Rule Change Relating to the Permanent Approval of the Elimination of Position and Exercise Limits for FLEX Equity Options

December 10, 1999.

I. Introduction

On October 5, 1999, October 13, 1999, and November 4, 1999, the American Stock Exchange LLC (''Amex''), Pacific Exchange, Inc. (''PCX''), and the Chicago Board Options Exchange, Inc. (''CBOE'') (collectively, the ''Exchanges''), submitted to the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'' or ''Act'') [1] and Rule 19b–4 thereunder, [2] proposed rule changes to make permanent their pilot programs to eliminate position and exercise limits for FLEX Equity options.

The proposed rule changes were published for comment in the **Federal Register** on November 11, 1999. [3] No comments were received on the proposals. This order approves the proposals on an accelerated basis.

II. Background and Description

On February 14, 1996 and June 19, 1996, the Commission approved the Exchanges' proposals to list and trade FLEX Equity options on specified equity securities. [4] According to the Exchanges, those proposals were designed to provide investors with the ability, within specified limits, to designate certain terms of the options. In support of their proposals, the Exchanges stated that in recent years, an over-the-counter (''OTC'') market in customized equity options had developed which permitted participants to designate the basic terms of the options including size, term to expiration, exercise style, exercise price, and exercise settlement value. According to the Exchanges, participants in this OTC market were typically institutional investors, who bought and sold options in large-size transactions through a relatively small number of securities dealers. To compete with this growing OTC market in customized equity options, the Exchanges proposed to expand their FLEX options rules [5] to permit the introduction of trading in FLEX options on specified equity securities that satisfied the Exchanges' listing standards for equity options. [6] The Exchanges' proposals allowed FLEX Equity option market participation to designate the following contract terms: (1) certain exercise prices; [7] (2) exercise style (*i.e.,* American, European, or capped); [8] expiration date; [9] and (4) option type (*i.e.,* put call, or spread). In addition, the Exchanges set position and exercise limits for FLEX Equity options at three times the position limits for the corresponding Non-FLEX Equity options on the same underlying security. [10]

Thereafter, on September 9, 1997, the Commission approved proposed rule change from the Exchanges eliminating position and exercise limits for FLEX Equity options on a two-year pilot basis. [11] In addition to eliminating position and exercise limits, the pilot program required that a member or member organization (other than a Specialist or Registered Options Trader) report to the Exchange information for each account that maintains a position on the same side of the market in excess of three times the position limit level established pursuant to the applicable exchange rule for Non-Flex Equity options of the same class. The report included information regarding the FLEX Equity option position, positions in any related instrument, the purpose or strategy for the position, and the collateral used by the account. [12]

Furthermore, the Commission, in its order approving the pilot program, required each of the Exchanges to submit a report containing a description of: (i) the types of strategies used by FLEX Equity options market participants and whether FLEX Equity options are being used in lieu of existing standardized equity options; (ii) the type of market participants using FLEX Equity option both before and during the pilot program, including how the utilization of FLEX Equity options has changed; (iii) the average size of FLEX Equity option contracts both before and during the pilot program, the size of the largest FLEX Equity option contract on any given day both before and during the pilot program, and the size of the largest FLEX Equity option held by any single customer/member both before and during the pilot program; and (iv) any impact on the prices of underlying stocks during the establishment or unwinding of FLEX positions that are greater than three times the standard

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 42126 (November 10, 1999), 64 FR 63064 (November 18, 1999).

[4] *See* Securities Exchange Act Release Nos. 36841 (February 14, 1996), 61 FR 6666 (February 21, 1996) (File Nos. SR–CBOE–95–43 and SR–PSE–95–24), and 37336 (June 19, 1996), 61 FR 33558 (June 27, 1996) (File No. SR–Amex–95–57).

[5] *See e.g.,* Amex Rules 900G through 909G. At the time of their FLEX Equity option proposals, the Amex and the CBOE had already secured Commission approval to list and trade FLEX options on several broad-based market indexes composed of equity securities (''FLEX Index options''). *See, e.g.,* Securities Exchange Act Release Nos. 32781 (August 20, 1993), 58 FR 45360 (August 27, 1993) (order approving the trading of FLEX Index options on the Major Market, Institutional, and S&P MidCap Indexes) (File No. SR–Amex–93–05), and 34052 (May 12, 1994), 59 FR 25972 (May 18, 1994) (order approving the trading of FLEX Index options on the Nasdaq 100 Index) (File No. SR–CBOE–93–46).

[6] *See e.g.,* Amex Rule 915, containing initial listing standards for a security to be eligible for options trading. In addition, the Exchanges may trade FLEX options on any options-eligible security regardless of whether standardized Non-FLEX options overlie that security and regardless of whether such Non-FLEX options trade on the Exchanges.

[7] *See* Securities Exchange Act Release No. 37726 (September 25, 1996), 61 FR 51474 (October 2, 1996), regarding restrictions on the available exercise prices for FLEX Equity call options.

[8] An American-style option is one that may be exercised at any time on or before the expiration date. A European-style option is one that may be exercised only during a limited period of time prior to expiration of the option. A capped-style option is one that is exercised automatically prior to expiration when the cap price is less than or equal to the closing price of the underlying security for calls, or when the cap price is greater than or equal to the closing price of the underlying security for puts.

[9] The expiration date of a FLEX Equity option cannot, however, fall on a day that is on, or within two business days of, the expiration date of a Non-FLEX Equity option.

[10] At that time, position and exercise limits for FLEX Equity options were set as follows as compared to then-existing limits for Non-FLEX Equity options on the same underlying security.

Non-FLEX Equity position limit	*FLEX Equity position limit*
4,500 contracts	13,500 contracts
7,500 contracts	22,500 contracts
10,500 contracts	31,500 contracts
20,000 contracts	60,000 contracts
25,000 contracts	75,000 contracts

Aggregation of positions or exercises in FLEX Equity options with positions or exercises in Non-FLEX Equity options was not required for purposes of the limits.

[11] *See* Securities Exchange Act Release No. 39032 (September 9, 1997), 62 FR 48683 (September 16, 1997) (approving File Nos. SR–Amex–96–19; SR–CBOE–96–79; SR–PCX–97–09).

[12] The Exchanges also required that an updated report be filed when a change in the options position occurred or when a significant change in the hedge of that position occurred. *See* Securities Exchange Act Release No. 39032 (September 9, 1997), 62 FR 48683 (September 16, 1997).

position limit. Each of the Exchanges has filed their reports, which will be discussed below.

On September 9, 1999, the Commission approved an extension of the pilot programs for another three months.[13] The current pilot programs expired on December 9, 1999. Accordingly, the Exchanges request approval of their programs on a permanent basis. All of the terms and conditions applicable under the current pilots, including the reporting requirements, will remain in effect after the proposals are approved permanently.[14]

III. Discussion

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, with the requirements of Sections 6 and 11A of the Act.[15] Specifically, the Commission believes that the rule proposals are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission also believes that the proposed rule changes are consistent with Section 11A of the Act in that the permanent elimination of position and exercise limits for FLEX Equity options allows the Exchanges to better compete with the growing OTC market in customized equity options, thereby encouraging fair competition among brokers and dealers and exchange markets. The attributes of the Exchanges' options markets versus an OTC market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, parameters and procedures for clearance and settlement, and the guarantee of the OCC for all contracts traded on the Exchanges.

The Commission has generally taken a gradual, evolutionary approach toward expansion of position and exercise limits. Given that the current pilot programs have run for the past two years without incident, the Commission believes that it is appropriate to approve the pilots on a permanent basis. First, the FLEX Equity options market is characterized by large, sophisticated institutional investors (or extremely high net worth individuals), who have both the experience and ability to engage in negotiated, customized transactions. For example, with a required minimum size of 250 contracts to open a transaction in a new series, FLEX Equity options are designed to appeal to institutional investors, and it is unlikely that many retail investors would be able to engage in options transactions at that size. Second, all of the Exchanges' other current rules and provisions governing FLEX Equity options remain applicable.[16] Third, the OCC will serve as the counter-party guarantor in every exchange-traded transaction. Fourth, the proposed elimination of position and exercise limits for FLEX options could potentially expand the depth and liquidity of the FLEX equity market without significantly increasing concerns regarding intermarket manipulations or disruptions of the options or the underlying securities. Fifth, the enhanced reporting requirements should help the Exchanges to monitor accounts under risk and to take any appropriate action. Finally, the Exchanges' surveillance programs will be applicable to the trading of FLEX Equity options and should detect and deter trading abuses arising from the elimination of position and exercise limits.

As described above, the Exchanges have adopted important safeguards that will allow them to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if necessary. The Exchange require each member or member organization (other than a Specialist, a Registered Options Trader, a Market Maker, or a Designated Primary Market Maker) that maintains a position on the same-side of the market in excess of three times the position limit level established pursuant to the applicable exchange rule for Non-FLEX Equity options of the same class to report information to the exchange regarding the FLEX Equity option position, positions in any related instrument, the purpose or strategy for the position, and the collateral used by the account. By monitoring accounts in excess of three times the Non-FLEX Equity option position limit in this manner, the Exchanges should be provided with the information necessary to determine whether to impose additional margin and/or whether to assess capital charges upon a member organization carrying the account. In addition, this information should allow the Exchanges to determine whether a large position could have an undue effect on the underlying market and to take the appropriate action.

The Commission believes that it is reasonable to treat FLEX Equity options differently than regular standardized options. FLEX options compete directly with the OTC options. The Commission believes that it would be beneficial to attract OTC activity back to a more transparent market with a clearinghouse guarantee. Hence, a liberalization of position limits for FLEX Equity options is a measured deregulatory means to enable the Exchanges to compete with the OTC market while preserving important oversight safeguards.

As noted above, each of the Exchanges was required to submit a report assessing the effects of the pilot programs. This information was required to allow the Commission to evaluate the consequences of the programs and to determine whether permanent approval was appropriate. The Commission has reviewed these reports. Although the Commission cannot entirely rule out the potential for future adverse effects on the securities markets for the FLEX Equity options or component securities underlying FLEX Equity options, the reports support permanent approval of the pilots because such effects and abuses have not occurred over the two year pilot period.

In reports, the Exchanges indicate that their experiences with the pilot programs have been positive. Generally, none of the Exchanges note a change in the types of strategies used by FLEX Equity options market participants, nor do they believe that market participants are using FLEX Equity options in lieu of existing standardized equity options. Although the PCX experienced new activity by market makers, the Exchanges generally indicate that the types of market participants using FLEX Equity options during the pilots remained consistent to those using the product before the elimination of position and exercise limits. The average size of the FLEX Equity option contract increased to varying degrees on all of the Exchanges. The size of the largest FLEX Equity option contract also increased to varying degrees on each of the Exchanges during the pilots. Despite

[13] *See* Securities Exchange Act Release No. 41848 (September 9, 1999), 64 FR 50846 (September 20, 1999).

[14] Telephone call between Tim Thompson, CBOE, and Christine Richardson, on December 10, 1999; telephone call between Robert Pacileo, PCX, and Christine Richardson, on December 10, 1999. The Amex proposal explicitly states that the same terms and conditions applicable during the pilot will remain in effect after the proposal is permanently approved.

[15] *See* 15 U.S.C. 78f(b) and 78k–1. In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with Section 3 of the Act. *Id.* at 78c(f).

[16] *See, e.g.,* Amex Rules 900G through 909G.

this increase, FLEX Equity options represented a very small percentage of options transactions when compared to the standardized equity market. Further, although each of the Exchanges generally experienced an increase in trading activity and size of contracts during the pilot period, a very insignificant number of positions actually exceeded three times the standardized options position limit. Based on the above, the Exchanges concluded that the elimination of position and exercise limits for FLEX Equity options did not have any impact on the prices of the underlying stocks during the establishment or unwinding of FLEX Equity positions greater than three times the standard position limit.

Finally, given the size and sophisticated nature of the FLEX Equity options market, the reporting and margin requirements, and the fact that the pilot programs have run the past two years without incident, the Commission believes that eliminating position and exercise limits for FLEX Equity options on a permanent basis does not substantially increase manipulative concerns. The Commission continues to believe that the enhanced market surveillance of large positions should help the Exchanges to take the appropriate action in order to avoid any manipulation or market risk concerns. The Commission expects the Exchanges to take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in FLEX options and the underlying stocks, should any unanticipated adverse market effects develop. In summary, because of the special nature of the FLEX Equity markets, the Commission believes that the Exchanges' proposals should be approved on a permanent basis. In permanently approving the proposals, the Commission believes that the distinctions between the FLEX Equity options market and the standardized equity options market, as described above, warrant the different regulatory applications of position and exercise limits under the Act.

The Commission finds good cause for approving the proposed rule changes prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Specifically, the Commission believes that because approval of the permanent approval of the proposals will allow the pilot programs to continue uninterrupted based on the same terms and conditions of original pilot, it is consistent with the protection of investors and the public interest to approve the proposed rule changes on an accelerated basis. Further, a full 21-day comment period was provided and no comments were received. Accordingly, the Commission believes it is consistent with Section 6(b)(5) and Section 19(b)(2) of the Act to grant accelerated approval to the proposed rule changes.[17]

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[18] that the proposed rule changes (SR–Amex–99–40; SR–PCX–99–41; SR–CBOE–99–59) be approved.

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

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42224; File No. SR–NYSE–94–34]

Self-Regulatory Organizations; Notice of Filing of Amendment No. 5 to Proposed Rule Change by the New York Stock Exchange, Inc. to Revise Exchange Rule 92, ''Limitations on Members' Trading Because of Customers' Orders''

December 13, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on October 28, 1999, the New York Stock Exchange, Inc. (''Exchange'' or ''NYSE'') filed with the Securities and Exchange Commission (''Commission'') Amendment No. 5 to the proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

As originally filed in 1994, the proposed rule change would amend Exchange Rule 92 (''Rule 92'') to permit NYSE member organizations to trade along with their customers when such member organizations liquidate a block facilitation position or engage in bona fide arbitrage or risk arbitrage. Amendment No. 5 to the proposal clarifies the limited exception for transactions effected to hedge a customer facilitation position, and provides further explanation of how the revised Rule 92 will operate.

The following is the text of the proposed rule change marked to reflect all of the proposed changes.[3] Additions to the current text of Exchange Rule 92 appear in *italics* while deletions appear in [brackets].

Rule 92: Limitations on Members' Trading Because of Customers' Orders

[(a) No member shall (1) personally buy or initiate the purchase of any security on the Exchange for his own account or for any account in which he, his member organization or any other member, allied member or approved person, in such organization or officer thereof, is directly or indirectly interested, while such member personally holds or has knowledge that his member organization holds an unexecuted market order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security on the Exchange for any such account, while he personally holds or has knowledge that his member organization holds an unexecuted market order to sell such security in the unit of trading for a customer.

(b) No member shall (1) personally buy or initiate the purchase of any security on the Exchange for any such account, at or below the price at which he personally holds or has knowledge that his member organization holds an unexecuted limited price order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security on the Exchange for any such account at or above the price at which he personally holds or has knowledge that his member organization holds an unexecuted

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[17] 15 U.S.C. 78f(b)(5) and 78s(b)(2).

[18] 15 U.S.C. 78s(b)(2).

[19] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] As presented, the text of the proposed rule change incorporates all of the proposed changes made to the original rule proposal by Amendment Nos. 1, 2, 3, 4, and 5. *See* Securities Exchange Act Release Nos. 35139 (Dec. 22, 1994), 60 FR 156 (Jan. 3, 1995) (notice of filing of proposed rule change, including Amendment No. 1); 36015 (July 21, 1995), 60 FR 38875 (July 28, 1995) (notice of filing of Amendment No. 2); 37428 (July 11, 1996), 61 FR 37523 (July 18, 1996) (notice of filing of Amendment No. 3); 39634 (Feb. 9, 1998), 63 FR 8244 (Feb. 18, 1998) (notice of filing of Amendment No. 4). On November 22, 1999, the Exchange submitted a technical correction to Amendment No. 5 to better identify the cumulative proposed changes to Exchange Rule 92. *See* Electronic mail message from Donald Siemer, Director, Market Surveillance, Exchange, to Michael L. Loftus, Special Counsel, Division of Market Regulation, Commission, dated November 22, 1999.