

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-37438; File No. SR-OCC-96-05]

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change Relating to the Issuance, Clearance, and Settlement of DIVS, OWLS, and RISKS

July 15, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on March 19, 1996, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared primarily by OCC. On June 20, 1996, OCC filed an amendment to the proposed rule change.² The Commission is publishing this notice to solicit comments from interested persons.

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

The purpose of the proposed rule change is to amend certain OCC by-laws and rules and to append new sections to OCC's by-laws and rules to provide for the issuance, clearance, and settlement of new equity derivative products referred to as Dividend Value of Stock ("DIVS")sm, Options with Limited Stock ("OWLS")sm, and Residual Interest in Stock ("RISKS")sm.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B),

and (C) below, of the most significant aspects of such statements.³

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The proposed rule change will amend certain OCC by-laws and rules and will append new sections to OCC's by-laws and rules to permit the issuance, clearance, and settlement of new equity derivative products referred to as DIVS, OWLS, and RISKS. DIVS, OWLS, and RISKS are proposed to be listed and traded on the Philadelphia Stock Exchange ("PHLX").⁴

1. Description of DIVS, OWLS, and RISKS

Each of these three new options-related products will be traded separately on the PHLX equity option floor. It is intended that an investor who owns all three will be in an economic position similar to an investor who owns the underlying stock except that ownership of DIVS, OWLS, and RISKS will not give the holder voting rights. PHLX has indicated that it intends to introduce new series of DIVS, OWLS, and RISKS in a coordinated way so that whenever a series of DIVS on a particular underlying stock is opened for trading a series of OWLS and a series of RISKS with the same termination date also will be open for trading.⁵ In addition, OWLS and RISKS in the coordinated series will have the same termination claim, which is a concept similar to the strike price of an option. OWLS and RISKS will be considered European style products in that they cannot be exercised prior to expiration.

Each DIVS given the holder the right to receive and obligates the writer to pay on the termination date dividend equivalents on a per share basis equal to any regular dividends distributed to stockholders by the issuer of the underlying stock. However, certain distributions may be reflected in an adjustment to the unit of trading or to the number of outstanding DIVS rather than in a dividend equivalent payment.

Specifically, each OWLS gives the holder the right to receive and obligates the writer to pay on the termination date either (i) the number of shares of the security underlying the OWLS (i.e., the unit of trading, which usually is 100 shares) if the closing price of the underlying security at expiration of the OWLS is less than or equal to the termination claim or (ii) the number of shares of the underlying security equal in value to the termination claim times the unit of trading if the closing price is greater than the termination claim. In other words, the maximum value that the OWLS holder will receive is fixed at the aggregate amount of the termination claim, but that value always will be paid in stock rather than in cash.

Accordingly, if the closing price at expiration is greater than the termination claim, the number of shares received by the holder will be less than the unit of trading for the OWLS, and if the closing price at expiration is less than or equal to the termination claim, the holder will receive the number of shares of the underlying security represented by the unit of trading.⁶ Therefore, holding an OWLS functionally resembles a covered call writing transaction (i.e., a purchase of the underlying stock combined with the sale of a European style call option on that stock). However, unlike the writer of a covered call that expires in the money, the OWLS holder will receive stock instead of cash upon settlement.

Each RISKS gives the holder the right to receive a number of shares of the stock underlying the RISKS equal in value to the excess, if any, of the closing price of the underlying security at the termination date over the termination claim of the RISKS times the unit of trading.⁷ If the closing price of the underlying security is less than or equal to the termination claim, the RISKS will expire worthless, and the holder will

⁶ For example, if the termination claim for a series of OWLS is \$50, the unit of trading is 100 shares, and the closing price for the underlying stock at termination of the OWLS is \$80, holders of OWLS would be entitled to receive the number of shares of the underlying stock having an aggregate market value of $100 \times \$50 = \5000 per OWLS held. Accordingly, since $\$5000/\$80 = 62.5$ shares, the holder would be entitled to receive 62 whole shares per OWLS held and a cash payment in lieu of any fractional share. However, if the closing price of the stock had been \$50 or less (i.e., equal to or less than the termination claim of the OWLS), the OWLS holder would receive 100 shares per OWLS held.

⁷ For example, a holder of RISKS in a series corresponding to the series of OWLS referred to in the preceding example would be entitled to receive an aggregate number of shares of stock underlying the RISKS equal in value to: $100 \times (\$80 - \$50) = \$3000$. Since $\$3000/\$80 = 37.5$ shares, a RISKS holder would be entitled to receive 37 shares per RISKS held and a cash payment in lieu of any fractional share.

⁸ 17 CFR 200.30-3(a)(12) (1995).

¹ 15 U.S.C. § 78s(b)(1) (1988).

² Letter from Michael G. Vitek, OCC, to Jerry W. Carpenter, Assistant Director, Division of Market Regulation, Commission (June 19, 1996).

³ The Commission has modified the text of the summaries prepared by OCC.

⁴ For description of the PHLX proposal to list and trade DIVS, OWLS, and RISKS, refer to Securities Exchange Act Release No. 36127 (August 28, 1995), 60 FR 44533 [File No. SR-PHLX-95-19] (notice of proposed rule change relating to DIVS, OWLS, and RISKS). To the extent that discrepancies exist between the present filing and SR-PHLX-95-19, OCC believes that this filing represents the current intentions of PHLX, and OCC anticipates that PHLX will amend its filing to eliminate any inconsistencies.

⁵ The expiration date of a series of DIVS, OWLS, and RISKS may have an expiration date up to 60 months following the issuance date of such series.

receive nothing. Accordingly, holding a RISKS functionally resembles holding a call option except that the RISKS holder receives any in-the-money value of the option in kind, (*i.e.*, by receipt of a number of shares of the underlying security equal to the in-the-money value) as differentiated from a call option holder who either will (i) pay an exercise price to purchase the underlying shares and then sell such shares or (ii) enter into a closing transaction to capture the in-the-money value.

Writers of OWLS and RISKS will have obligations corresponding to the rights of holders. With respect to OWLS, some performance, which will ordinarily be delivery of some amount of the underlying stock, will always be due at termination. However, RISKS that expire at-the-money or out-of-the-money will terminate without any performance being required. RISKS that are in-the-money at expiration automatically will require writers to deliver and entitle holders to receive the underlying stock without regard to any notice of exercise. Similarly, no exercise of DIVS will be required in order to entitle the holder to receive and to obligate the writer to pay dividend equivalents during the term of the DIVS. Accordingly, the concepts of exercise and assignment are not used in relation to DIVS, OWLS, and RISKS.

2. Proposed Amendments to OCC's By-Laws

The proposed rule change will make amendments to Article I of OCC's by-laws regarding definitions that will include minor changes and additions to several defined terms in order to indicate how such terms will apply to DIVS, OWLS, and RISKS. In certain cases where DIVS, OWLS, and RISKS are simple to be included with other OCC-issued securities, this has been done by substituting the general term "cleared security" for an existing list of products rather than adding three more product names to the list. Definitions of the terms DIVS, OWLS, and RISKS also have been added.

The proposed rule change also will amend Article VI of the by-laws regarding clearance of exchange transactions to make minor changes and additions to several sections in order to make these by-laws applicable to transactions in DIVS, OWLS, and RISKS. Interpretation .01 to Article VI, Section 9 of the by-laws will be amended to make clear that subsections (a) and (b) of Section 9 apply only to stock options.⁸ Provisions parallel to

those found in Section 9 that will be applicable to DIVS, OWLS, and RISKS appear in new Article XXV of OCC's by-laws.

Section 11 of Article VI regarding adjustments will be amended to provide that the OCC Securities Committee shall have the authority to make adjustments to DIVS, OWLS, and RISKS pursuant to the same procedures utilized for adjustments to other options. Although other provisions of Section 11 may also be applicable to DIVS, OWLS, and RISKS, the precise way in which those provisions will be applied will be set forth in new Article XXV of the by-laws. Article VIII of the by-laws regarding the stock clearing fund also will be amended to include minor additions to several sections to include DIVS, OWLS, and RISKS.

3. Proposed Article XXV of OCC's By-Laws

The introduction to proposed Article XXV makes clear that OCC's by-laws in Articles I through XI also are applicable to DIVS, OWLS, and RISKS, except where expressly modified or made inapplicable by Article XXV. Following the convention observed in the by-laws relating to other products, the effect of each by-law section in Article XXV on other by-laws will be stated in brackets at the end of each section in Article XXV.

Proposed Article XXV, Section 1 adds certain new definitions relevant to DIVS, OWLS, and RISKS and redefines certain terms defined in Article I of the by-laws to assign different meanings when those terms are used with respect to DIVS, OWLS, and RISKS. With respect to DIVS, the term "dividend payable date" has been defined to mean the date on which the dividend equivalent is required to be paid by the writer of a DIVS to OCC and by OCC to the holder of a DIVS. The term "ex dividend date" has been defined to mean the "ex" date for the corresponding dividend on the underlying security.

As a result of the foregoing definitions, the right of a DIVS holder to receive and the obligation of a DIVS writer to pay a dividend equivalent will be fixed at the close of trading on the business day preceding the ex dividend date. The actual payment may occur days or weeks later to coincide with the payable date for the corresponding dividend on the underlying stock. It is desirable to harmonize these payable dates in order to make hedging and other strategies involving combined

positions in DIVS and the underlying stock most efficient. As a result, it is possible that an obligation to pay or right to receive a dividend equivalent that accrued prior to the termination date of a DIVS will remain outstanding after the termination date. OCC simply will continue to carry the dividend equivalent right or obligation in a manner similar to a settlement obligation of an exercised option.

As defined in Article XXV of OCC's by-laws, the "termination settlement date" for a particular series of OWLS and RISKS is the date on which performance is to be rendered with respect to the terminated OWLS and, if any settlement is due, the terminated RISKS. OCC Rule 2602 specifies that the settlement date will be the third business day following the termination date.

The term "closing price" will be defined to mean the closing price for the underlying security on the primary market on the business day prior to the termination date of OWLS or RISKS. However, the exchange may provide that the closing price be based on an average of prices of the underlying security near the close of business on that day. The exchange must specify that it intends to use an average of prices prior to the opening of trading in any series of OWLS or RISKS.

The proposed definition of "termination claim" provides that any reference to the term "exercise price" will refer to the termination claim of OWLS or RISKS. As stated earlier, because notice of exercise is not required at the termination of an OWLS or RISKS, the concept of "exercise" has no relevance to OWLS or RISKS.

As proposed, Article XXV, Section 2 sets forth the general rights and obligations of holders and writers of DIVS, OWLS, and RISKS. Article XXV, Section 3 sets forth the agreements of a writing clearing member when effecting an opening writing transaction in DIVS, OWLS, or RISKS.

As proposed, Section 4 of Article XXV describes the application of the adjustment rules of Article VI, Section 11 of OCC's by-laws to DIVS, OWLS, and RISKS. In addition, Section 4 provides general and discretionary guidelines as to how the OCC securities committee will ordinarily make adjustments for DIVS, OWLS, and RISKS.

Proposed Section 5 of Article XXV provides that Section 19 of Article VI relating to the shortage of underlying securities is applicable to OWLS and RISKS except that restrictions on exercises, an action that can be taken with respect to put options, cannot be

⁸ Section 9(a) relates to the rights and obligations of call option holders and writers. Section 9(b)

concerns the rights and obligations of put option holders and writers.

applied to OWLS or RISKS because OWLS and RISKS are not exercisable.

Article XXV, Section 6 sets forth the steps OCC may take in the event the closing price for an underlying security is unavailable. In addition to any other actions OCC may be entitled to take under its by-laws and rules, OCC may suspend settlement obligations for the affected OWLS and RISKS. OCC also will have the authority to fix the closing price for purposes of termination settlement of OWLS and RISKS by means of a panel consisting of exchange representatives and the chairman of OCC. Provisions in paragraph (b) and Interpretation .01 of Article XXV, Section 6, which relates to the finality of the closing price as officially announced by OCC, are similar to provisions applicable to closing index values for index options.

4. Proposed Amendments to Existing Rules

Proposed amendments to existing rules include minor additions to several rules in order to include how those rules will apply to DIVS, OWLS, and RISKS. Many changes are self-explanatory and therefore are not described in this notice.⁹

Proposed amendments to Rule 601 regarding margins sets forth that DIVS, OWLS, and RISKS will be margined in the same manner as equity options and will utilize the OCC Theoretical Intermarket Margining System ("TIMS").¹⁰

Proposed changes to Rule 1001, which relates to clearing fund contributions, provide that positions in DIVS, OWLS, and RISKS will be included in the formula to determine clearing members' proportionate contributions to the stock clearing fund. This is consistent with DIVS, OWLS, and RISKS also being included with stock options for purposes of margin calculations and clearing member qualifications.

Rules 1104 and 1106 regarding the liquidation of an account of a clearing member upon suspension of that clearing member are being amended to include reference to positions in DIVS, OWLS, and RISKS. Rule 1106(b)(2) will be amended to contain a reference to specific or escrow deposits with respect

to DIVS, OWLS, and RISKS. No provisions for such deposits are included in the present filing; therefore, these references will have no application until such time as OCC provides for escrow deposits with respect to DIVS, OWLS, and RISKS.¹¹

5. Proposed Chapter XXVI of the Rules

The introduction to proposed Chapter XXVI makes it clear that the rules in Chapters I through VII and IX through XII also are applicable to DIVS, OWLS, and RISKS except where expressly modified or made inapplicable by Chapter XXVI. The effect on other rules by each section in Chapter XXVI is stated in brackets at the end of each section in Chapter XXVI.

Proposed Rule 2601 of Chapter XXVI sets forth the rights and obligations of holders and writers of DIVS with respect to the payment of dividend equivalents. Under the proposed rule, the holder of a DIVS is entitled to the equivalent of the regular dividend payments that a shareholder of the underlying security with a comparable position (*i.e.*, one hundred shares) would receive. The writer is obligated to pay or deliver the dividend equivalent of an ordinary dividend or a non-cash dividend distribution to the holder of the DIVS. Certain distributions may result in an adjustment of the DIVS in lieu of a dividend equivalent while other distributions may give rise to only a dividend equivalent or both a dividend equivalent and an adjustment. Proposed Rule 2601 specifies that on the dividend payable date, OCC will notify each clearing member having a position in DIVS of the net sum it is required to pay or entitled to receive.

Proposed Rule 2602 provides that the termination settlement date for a particular series of OWLS and RISKS will be the third business day following the termination date. Rule 2603 sets forth the termination settlement procedures for OWLS and RISKS. The number of shares of the underlying stock that are deliverable upon termination of OWLS is determined under paragraph (a) of Rule 2603. The number of shares, if any, deliverable upon termination of RISKS is determined under paragraph (b) of Rule 2603. The procedures applicable to both OWLS and RISKS for delivery of shares and payment of cash settlements in lieu of fractional shares are set forth in paragraphs (c) and (d), respectively, of Rule 2603.

Rule 2603(c) sets forth the procedures for the delivery of stock in settlement of OWLS and RISKS. Settlement for OWLS and RISKS will be effected in the same way that stock is delivered in the settlement of exercised stock options which ordinarily occurs through stock clearing corporations. Rule 2603(d) provides that cash in lieu of fractional shares will be paid through OCC's regular cash settlement system. In the event the OWLS and RISKS cannot be settled through regular-way settlement, they will be settled on a broker-to-broker basis as governed by Rule 902.

OCC believes the proposed rule change is consistent with the requirements of Section 17A of the Act and the rules and regulations thereunder because the rule proposal should facilitate the prompt and accurate clearance and settlement of transactions in DIVS, OWLS, and RISKS. OCC also believes the proposed change is consistent with the safeguarding of funds and securities in OCC's custody or control or for which OCC is responsible because OCC will apply to DIVS, OWLS, and RISKS a system of safeguards which is substantially the same as that which OCC currently uses for options and other OCC-issued products.

(B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change will impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

Comments were not and are not intended to be solicited by OCC with respect to the proposed rule change, and none were received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which OCC consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

⁹ The text of the specific changes being made to OCC's rules is set forth in *Exhibit A* to OCC's proposed rule change which is available through OCC or the Commission's Public Reference Room.

¹⁰ Equity TIMS is used to calculate clearing margin for participants' positions in equity options. For a complete description of equity TIMS, refer to Securities Exchange Act Release No. 36003 (July 21, 1995), 60 FR 38880 [File No. SR-OCC-95-07] (order approving use of equity TIMS on a temporary basis).

¹¹ Prior to providing for specific or escrow deposits with respect to DIVS, OWLS, or RISKS, OCC will be required to file a proposed rule change with the Commission under Section 19(b) of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submission should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington D.C. 20549. Copies of the submissions, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change 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, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filings will also be available for inspection and copying at the principal office of OCC. All submissions should refer to the file number SR-OCC-96-05 and should be submitted by August 14, 1996.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-37452; International Series Release No. 1006; File No. SR-PSE-96-15]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Pacific Stock Exchange, Inc. Relating to Investment Company Units

July 17, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on June 3, 1996, the Pacific Stock Exchange Incorporated ("PSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. On July 2, the PSE filed Amendment No. 1 to its proposal.² The Commission is

publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to establish listing standards for Investment Company Units ("Units"), and to trade Units known as "CountryBaskets" ("CBs") pursuant to unlisted trading privileges ("UTP").

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The Exchange proposes to adopt new rules relating to listing standards for Units. Units represent an interest in a registered investment company ("Investment Company" or "Fund") that could be organized as a unit investment trust ("UIT"), an open-end management investment company, or a similar entity. Under the proposed rules, the Investment Company would be required either to: (i) Hold securities comprising or otherwise based on or representing an interest in an index or portfolio of securities, or (ii) hold securities in another registered investment company. The Investment Company would then issue Units in a specified aggregate number in return for a deposit either of: (i) Shares of securities comprising or otherwise based on the relevant index or portfolio, or (ii) shares of a registered investment company. In addition to or instead of the "in-kind" deposit, the Investment Company might require a cash deposit. Thus, Units could represent an interest in series of an open-end management investment company investing in a portfolio of securities ("Fund-only structure"). Alternatively, Units could represent an

interest in UITs that have as their assets shares of an open-end investment company holding a portfolio of securities ("Fund/UIT structure"). Unit holders would receive periodic cash payments corresponding to the regular cash dividends or distributions declared with respect to the securities held by the Investment Company (after subtracting applicable expenses and charges.)

The Exchange also proposes to trade, pursuant to UTP, Units known as "CountryBaskets" or "CBs." These securities were approved recently for listing on the New York Stock Exchange, Inc. ("NYSE").³ The nine series of CBs are based on the following Financial Times/Standard & Poor's Actuaries World ("FT/S&P") Indices: Australia; France; Germany; Hong Kong; Italy; Japan; South Africa; United Kingdom; and the United States. The Exchange notes that pursuant to Rule 12f-5 under the Act,⁴ prior to trading a particular class or type of security pursuant to UTP, the Exchange must have listing standards comparable to those of the primary exchange on which the security is listed. Hence, the PSE's proposed listing standards for Units are similar to the listing standards for Units adopted by the NYSE.⁵

1. Creation and Redemption of the Securities

Consistent with the proposed listing standards, Units, including CBs, will be distributed in transactions with the Fund ("Creation Transactions"). As noted above, the PSE proposal sets forth listing standards applicable both to a Fund-only structure and a Fund/UIT structure. The nine CB series the PSE proposes to trade rely on the Fund-only structure. To effect a Creation Transaction using the Fund-only structure, a person buys Fund shares from the Fund at their net asset value ("NAV") next computed. Sales occur in "Creation United" size aggregations in exchange for a deposit ("Deposit") of a basket of securities reflecting the securities underlying the Fund ("Index Securities") and a specified amount of cash sufficient to equal the NAV of Fund shares.⁶ Creation Unit size

³ See Exchange Act Release No. 36923 (March 5, 1996), 61 FR 10410.

⁴ 17 CFR 240.12f-5.

⁵ Amendment No. 1, *supra* note 2.

⁶ *Id.* If the alternative Fund/UIT structure were used, a person would effect a Creation Transaction by buying a Fund share (or fractional share) in exchange for the Deposit. Each UIT would invest solely in shares of a specified series of the Fund, and would offer one "redeemable unit of beneficial interest" (a "Redeemable Unit") in exchange for each Fund share or fractional share. The Redeemable Unit would be the functional

Continued

¹ 17 CFR 200.30-3(a)(12) (1995).

¹² 15 U.S.C. 78s(b)(1) (1988).

² Amendment No. 1 clarifies that the PSE seeks to trade CountryBaskets pursuant to unlisted trading privileges. Letter from Michael D. Pierson, Senior Attorney, Regulatory Policy, PSE, to Francois Mazur, Attorney, Division of Market

Regulation, Commission, dated July 1, 1996 ("Amendment No. 1").