

April 25, 1997.

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38541; File No. SR-CBOE-97-14]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Inc., Order Approving Proposed Rule Change Relating to the Issuance of Trading Permits and Other Procedures Resulting from the Transfer of the Options Business of the New York Stock Exchange to the Chicago Board Options Exchange

April 23, 1997.

#### I. Introduction

On March 3, 1997, 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"),<sup>1</sup> and Rule 19b-4 thereunder<sup>2</sup> a proposed rule change relating to issues arising from the transfer of the New York Stock Exchange's ("NYSE") options business to the CBOE. The proposed rule change was published for comment in Securities Exchange Act Release No. 38375 (March 7, 1997), 62 FR 12667 (March 17, 1997). The Commission received two comment letters in response to the proposal.<sup>3</sup>

#### II. Description of the Proposal

The purpose of the proposed rule change is to authorize the issuance of 75 "Options Trading Permits" ("Permits") in connection with the proposed transfer of the NYSE's options business to CBOE, and to define the rights and obligations associated with such Permits.<sup>4</sup> In addition, the proposed rule change amends CBOE rules as necessary to provide for the trading on CBOE of options on the NYSE Composite Index. The 75 Permits are proposed to be issued pursuant to the terms of an

agreement between CBOE and NYSE. The agreement represents the culmination of a process initiated by NYSE in the summer of 1996 when it announced that it intended to discontinue its options business. At that time, NYSE invited interested parties wishing to continue NYSE's options business to bid for its acquisition by offering trading rights and other benefits to NYSE members, including payment for the "going business" value of the business to be acquired. Based on its bid in response to NYSE's invitation, NYSE determined to enter into exclusive negotiations with CBOE. A definitive agreement between CBOE and NYSE ("Transfer Agreement") was executed as of February 5, 1997.<sup>5</sup>

The Transfer Agreement contemplates that trading in NYSE Options<sup>6</sup> will commence on the CBOE trading floor on April 28, 1997, ("Effective Date"), subject to the fulfillment of specified conditions and the approval of this proposed rule change and the parallel filing by NYSE.<sup>7</sup> The Transfer Agreement provides that CBOE will pay \$5,000,000 as the purchase price for the business to be transferred, of which \$1,200,000 will be retained by NYSE to cover its costs associated with the termination of its options activities and as payment for a ten-year license granted to CBOE to enable it to trade options on the NYSE Composite Index, and \$3,800,000 net of a tax reserve will be distributed pro rata to all NYSE members, or the NYSE Foundation, depending on the tax treatment by the Internal Revenue Service.<sup>8</sup>

The Transfer Agreement also provides that CBOE will issue up to a total of 75 Permits to those NYSE specialist and non-specialist firms and sole proprietors who operated pursuant to options trading rights on NYSE on December 5, 1996, and who agree to transfer their options activities to CBOE. In the case of a NYSE specialist, the specialist firm may select any qualified person to act as its nominee on CBOE. In the case of a non-specialist, the individual acting pursuant to an options trading badge on

NYSE on December 5, 1996, must personally relocate to Chicago in order to receive a Permit. If less than 75 Permits are issued to NYSE specialists and non-specialists, the Transfer Agreement provides that the difference between 75 Permits and the number of Permits so issued will be deposited in a lease pool to be leased to qualified persons who wish to trade NYSE Options on CBOE. The proceeds from the lease of these Permits will be paid to certain designated persons who held options trading rights on NYSE, as described below.

The issuance of 75 Permits is proposed to be authorized pursuant to a new Section 2(e) to the Exchange's Constitution. That section provides that all Permits expire on the seventh anniversary of the date when trading begins on the floor of CBOE in NYSE Options. It also specifies that Permit holders shall have none of the rights of members except as specified in the Rules of the Exchange.

The rights and obligations of holders of Permits are set forth in proposed new Exchange Rule 3.27, which incorporates by reference many of the other rules of the Exchange pertaining to the rights and obligations of Exchange members generally. Subparagraph (a)(1) of Rule 3.27 reflects the terms of the Transfer Agreement by providing that NYSE non-specialist firms and sole proprietors who were engaged in business on the options floor of NYSE immediately prior to the Effective Date are entitled to the same number of Permits as the number of options floor badges they held on NYSE on December 5, 1996, but that each individual who held an NYSE Options floor badge and acted as a non-specialist must personally relocate to Chicago in order to be entitled to a Permit in respect of that badge. Subparagraph (a)(2) provides that each specialist firm engaged in business on the options floor of NYSE is likewise entitled to the same number of Permits as the number of options floor badges they held on NYSE, and that, subject to the rules of CBOE, each such firm may designate any qualified person to be the firm's nominee on CBOE.

Subparagraph (a)(3) of Rule 3.27 describes the terms of the lease pool pursuant to which any of the 75 Permits not issued to NYSE members active on the NYSE options floor, or any so issued but subsequently surrendered, will be leased by CBOE through an auction or other competitive process. The lease proceeds would ordinarily be paid to those persons identified by NYSE as having used or leased NYSE Options trading rights on December 5, 1996, or holders of options trading rights that,

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Letters from Simon Erlich, Option Member, NYSE to Commission (March 10, 1997) ("Erlich Letter"); Michael Schwartz, Chairman, Committee on Options Proposals, to Jonathan G. Katz, Secretary, Commission (April 8, 1997) ("COOP Letter").

<sup>4</sup> See also Securities Exchange Act Release No. 38376 (March 7, 1997), 62 FR 12671 (March 17, 1997) (notice of filing of proposed rule change regarding the transfer of the NYSE options business to the CBOE).

<sup>5</sup> A copy of the Agreement is attached as Exhibit B to File No. SR-CBOE-97-14 and is available for review at the Office of the Secretary of CBOE, and in the Public Reference Room of the Commission.

<sup>6</sup> "NYSE Options" are defined as those classes of options that were traded on NYSE immediately prior to the Effective Date and not then also traded on CBOE, and those classes of options on at least 14 additional underlying stocks which CBOE has agreed to designate as NYSE Options during each of the seven years following the Effective Date.

<sup>7</sup> On April 23, 1997, the Commission approved the NYSE filing. See Securities Exchange Act Release No. 38542 (April 23, 1997).

<sup>8</sup> Details of the cash distribution to NYSE members were described in Item 3 of the parallel proposed rule change filed by NYSE.

while not so used or leased, were formally separated from their NYSE memberships on that date, or transferees of such persons.

Subparagraph (a)(4) of Rule 3.27 provides that if a Permit issued to a Options badge holder is not used during the first year following the Effective Date, the Permit shall be surrendered, and shall be added to the lease pool described above, unless the inactivity of the Permit has been consented to by CBOE.

Subparagraph (a)(5) of Rule 3.27 provides that Permits issued to NYSE Options badge holders pursuant to subparagraphs (a) (1) and (2) are not transferable for one year following the Effective Date, except as consented to by the Exchange in the event of death, hardship or certain successions in ownership. Following this one year period, Permits are freely transferable in accordance with Exchange rules governing the transfer of memberships generally.

Paragraph (b) of Rule 3.27 describes the trading rights to which the holder of a Permit is entitled. In general, these include the right to be admitted to the separate CBOE trading facility devoted exclusively to the trading of NYSE Options, as defined in the Rule, and to engage in the activities of a Market-Maker, Designated Primary Market-Maker ("DPM") and/or Floor Broker in respect of those options, subject to the applicable rules of the Exchange. In addition, the holder of a Permit is entitled to trade by order as principal those classes of options traded on CBOE's regular trading floor that were dually traded on both CBOE and NYSE immediately prior to the Effective Date. Permit holders are also entitled to trade by order as principal all other classes of options traded on CBOE's regular trading floor, provided that such trades during any calendar quarter (as measured by contract volume) do not exceed twenty percent of the sum of the permit holder's total in person principal trades in Options and the Permit holder's principal trades by order in options that were dually traded on both CBOE and immediately prior to the Effective Date. Finally, a Permit holder is entitled to be admitted to the regular options trading floor in order to respond to the call of a Board Broker or Order Book Official for additional market-makers pursuant to Exchange Rule 7.5.

Paragraph (c) of Rule 3.27 provides that each NYSE specialist firm to which a Permit is issued will be appointed as the DPM in the same classes of NYSE Options as those for which it was designated as a specialist on NYSE, subject to qualifying to act as such

pursuant to CBOE rules. Paragraph (c) also provides that the DPMs for the additional classes of NYSE Options designated each year shall be chosen from among Permit holders. Subject to the rules of the Exchange, specialist firms appointed as DPMs in NYSE Options shall be entitled to continue to act as such during the term of the Permits, and thereafter if they become regular members of the Exchange. CBOE will allocate to the new program securities underlying at least 14 new options classes per year for the first seven years after the transfer.

Paragraph (d) of Rule 3.27, together with Section 2(e) of the Exchange Constitution, provides that Permit holders shall have the same rights and obligations of members, except that they shall have no right to petition or vote or to be counted as part of a quorum at meetings of members, they shall have no interest in the assets or property of the Exchange, they shall not share in any distribution by the Exchange, they shall not participate in the Exchange's member death benefit program, and they shall not have the right to transact business with the public in any securities dealt in on the Exchange other than NYSE Options. Holders of Permits may serve on any committee of the Exchange to which they are appointed, and are deemed to be appointed market makers in all classes of NYSE Options pursuant to Exchange Rule 8.3.

Paragraph (d) also provides that membership application fees shall be waived in connection with the approval of Permit holders or their nominees in connection with the original issuance of a Permit but not the subsequent transfer or lease of a Permit, and shall also be waived in connection with the approval of the initial holder or its nominee as a regular member of the Exchange or as the nominee of a regular member. Membership or nominee applications made by Permit holders or their nominees who are not subject to a statutory disqualification and are not the subjects of a self-regulatory organization investigation that may involve their fitness for membership shall be deemed effective for a temporary period of six months, so as not to interrupt their Exchange activities while their applications are being processed.

CBOE also proposes to amend certain of the rules in Chapters XXIV and XXIVA of the Rules of the Exchange, which govern the trading of index options and FLEX options, respectively, in order to provide for the listing and trading of options on the NYSE Composite Index. (Hereafter, such index is referred to as the "Index" and such

options as "NYA Options".) The Index is a capitalization-weighted index comprising all of the over 2,500 common stocks listed on NYSE. The Index is expressed in relation to the base period market value which has been adjusted for capitalization changes over time. The base value of the Index was set at 50 on December 31, 1965. NYSE will continue to act as the reporting authority for the Index, and CBOE will trade NYA Options pursuant to a license granted by NYSE.

As traded on NYSE and as proposed to be traded on CBOE, NYA Options are European-style, A.M.-settled index options, strike prices for which are introduced at \$2.50 or \$5.00 intervals for strike prices below \$200 or at or above \$200, respectively. The Index Multiplier for NYA Options is \$100. CBOE proposes to apply to NYA Options the same 45,000 contract position and exercise limits (no more than 25,000 contracts expiring in the nearest expiration month) and the same hedge exemption that currently apply to such options under NYSE rules. In addition to regular index options, CBOE proposes to provide for trading in Quarterly Index Expiration options ("QIX" options), long-term and reduced-value long-term options ("LEAPS" and "reduced-value LEAPs") and A.M.-settled FLEX Options on the Index pursuant to the same rules and procedures that currently govern trading on CBOE in these types of options.

In addition, the proposed rule change includes a few corrections to the table of position limits set forth in Rule 24.4 in order to add references to classes of index options that were inadvertently omitted from the table when it was last revised, and a few clarifications to the language of Rule 24.4(b) concerning the specification of the exercise settlement values for FLEX Index Options. No substantive changes will result from these corrections and clarifications.

### III. Comments

The Commission received two comment letters regarding the proposed rule change.<sup>9</sup> The first commenter, Mr. Erlich, opposes the transfer of the options business, finding the agreement discriminatory and monopolistic.<sup>10</sup> Mr. Erlich believes that the agreement treats specialists as a class over other options members, and treats lease pool participants with separated options trading rights less favorably than those lease pool participants with unseparated option trading rights. The commenter

<sup>9</sup> See note 3 supra.

<sup>10</sup> See Erlich Letter.

finds the agreement monopolistic because it will result in more options being traded in fewer exchanges. Finally, Mr. Erlich questions how one exchange can sell to another exchange that which has been granted for free (*i.e.*, the right to sell options).

The second commenter, the COOP, is in favor of the proposal, stating that the relative size of the NYSE Options program coupled with its lack of automatic execution capability has led to cost inefficiencies.<sup>11</sup> The COOP believes that the efficiencies resulting from the consolidation of the NYSE Options market with CBOE will more than off-set the small reduction in intermarket competition.

#### IV. Discussion

The Commission believes CBOE's proposed rule change is consistent with Section 6(b)(5) of the Act.<sup>12</sup> Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, perfect the mechanism of a free and open national market system, and, in general, to further investor protection and the public interest.

Pursuant to the terms of the Transfer Agreement, CBOE proposes to distribute 75 Permits to those NYSE specialist and non-specialist firms and sole proprietors who operated pursuant to options trading rights on NYSE on December 5, 1996, and who agree to transfer their options activities to CBOE. The Commission believes the method by which the 75 Permits are distributed is equitable in that it will enable those holders of NYSE Option trading rights who actively traded NYSE Options as of December 5, 1996, to continue trading such options on the CBOE. The requirement that non-specialists must relocate to Chicago in order to obtain a Permit is a reasonable means of ensuring that a certain level NYSE Options trading expertise will be present at CBOE, and should help facilitate the smooth transition of trading in NYSE Options. By contrast, NYSE specialist firms may either trade in person on CBOE, or appoint any qualified person to be the firm's nominee. The NYSE has indicated that this distinction in treatment by CBOE among NYSE specialist and non-specialist firms reflects CBOE's desire to attract experienced traders, while encouraging all options specialists to participate in the transfer.<sup>13</sup>

The Commission believes it is within the reasonable business judgement of the CBOE to treat the two types of options traders differently. Due to the expertise of the specialist firms in trading NYSE Options, the capital commitment of the specialist firms, and the relationships they have established with order routing firms, it is reasonable for the CBOE to grant them more flexible Permits than other NYSE options members.

CBOE proposes to deposit into a "lease pool" any of the 75 Permits not issued to, or those Permits surrendered by, NYSE specialist and non-specialist firms. The Permits in the lease pool will be leased through an auction or other competitive process, with lease proceeds being paid to persons identified by the NYSE. The Commission believes that the creation of a lease pool and the distribution of the remaining Permits via a competitive process is an appropriate method for assessing and distributing such Permits. This will establish a mechanism that helps to assure that an acceptable number of options market making firms that trade NYSE Options, thereby promoting liquidity for those options. Furthermore, an auction or other competitive process is a fair and equitable manner of distributing the remaining Permits.

CBOE is requiring Permit holders to use the Permit during the first year following the Effective Date or otherwise surrender the Permit to the lease pool. The Commission believes this will encourage Permit holders to utilize their trading rights, and assure that the Permits are being used effectively and productively in the trading of NYSE Options. CBOE also proposes to limit the rights of Permit holders to transfer the Permits for one year following the Effective Date (except with the consent of CBOE). This restriction also appropriately serves to encourage Permit holders to maximize the use of the Permits. While the Permit holders are restricted from transferring the Permits for one year from the Effective Date, they may freely transfer the Permits thereafter. Furthermore, NYSE specialist firms are not forbidden from changing their nominee. Overall, the Commission believes the restrictions on the transfer of Permits in the first year will provide an acceptable method for CBOE to obtain the trading experts of the Permit holders during the transition in trading of NYSE Options, thereby encouraging a stable trading environment for NYSE Options.

CBOE's proposed rule change delineates clearly the trading rights to which holders of the Permits are

entitled (*i.e.*, as principal in options that were dually traded on CBOE and NYSE prior to the Effective Date, as well as other classes of options traded on CBOE's regular trading floor), and limits Permit holders' access to the separate CBOE trading facility, except in special instances. The Commission believes that the restrictions on Permit holders with regard to trading in former dually listed options and those options traded on CBOE's regular trading floor are appropriate requirements, consistent with the purpose of the Transfer Agreement. These limitations allow Permit holders to benefit from trading in dually listed options and options traded on CBOE's trading floor, while ensuring their concentration on the trading of NYSE Options. Moreover, the proposed limitations are merely limitations on the benefits afforded solely by the Permit. The Commission notes that CBOE encourages Permit holders to apply to become CBOE members. Once approved, such Permit holders would receive all the rights, and be subject to the same obligations, of other CBOE members.

CBOE proposes to appoint each NYSE specialist firm to which a Permit is issued as the DPM in the same classes of NYSE Options as those for which it was designated as a specialist on NYSE. The Commission believes this will assure a certain level of expertise in trading the various classes of options. Moreover, it will promote consistency and continuity in the trading of those options, thus facilitating the smooth trading of the NYSE Options business on the CBOE.

CBOE's proposal restricts Permit holders from transacting business with the public in any securities dealt in on the Exchange other than NYSE Options. The rule sets forth the limitations of the Permit, not the limitations of individuals who otherwise meet the Exchange's requirements, or the requirements of any other self-regulatory organization, for transacting such business with the public. For example, Permit holders who become members of the Exchange may transact business with the public if they meet the Exchange's requirements for doing so. The Commission believes this restriction is appropriate, in that it does not bar Permit holders, *per se*, but simply sets limits on the extent of the validity of the Permit itself.

CBOE proposes to waive membership application fees in connection with an application for approval as a Permit holder, and submission of an application for approval as a member of the Exchange. The Commission believes this provision is equitable, as it provides

<sup>11</sup> See COOP Letter.

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> See Securities Exchange Act Release No. 38376 (March 7, 1997), 62 FR 12671 (March 17, 1997).

an incentive for NYSE Options firms to continue their business at CBOE, while encouraging them to become regular members of the Exchange. The Commission believes that by waiving these fees, CBOE demonstrates its continued support for the NYSE Options firms who will transfer their activities to the Exchange.

CBOE is amending its rules regarding the trading of index options and FLEX options and providing for the listing and trading of the NYA Options. The Commission believes these changes will facilitate the transfer, and continued trading of, NYA Options at CBOE as they were traded on NYSE. CBOE proposes to provide for trading in QIX options, LEAPs and reduced-value Leaps and A.M.-settled FLEX Options on the Index pursuant to the same rules and procedures that currently govern trading on CBOE in these types of options. The Commission believes that the various types of options proposed by CBOE will enhance and encourage trading of NYA Options. In this regard, the Commission believes the rules and procedures currently governing trading on CBOE in these options will appropriately apply to NYA Options.

CBOE proposes to amend the table of position limits set forth in Rule 24.4 to add references to classes of index options that were previously omitted from the table when it was last revised. Further, CBOE proposes to clarify the language of Rule 24A.4(b) regarding specification of exercise settlement values for FLEX Index Options. The Commission believes these changes are reasonable as they merely clarify existing practice and will not result in substantive changes for CBOE members.

CBOE is constructing a new trading facility dedicated solely to NYSE Options which will be configured and equipped in the same manner as its existing trading floor. The surveillance and regulatory responsibilities resulting from the transfer of the NYSE Options business to CBOE are not expected to add significantly to CBOE's existing regulatory workload, and CBOE believes it has adequate resources to assume these added responsibilities. CBOE intends to add one additional output line to the Options Price Reporting Authority ("OPRA") processor for purposes of transmitting market information pertaining to NYSE Options. This will not increase the total input to OPRA because two lines from NYSE to the OPRA processor will be terminated at the time of the transfer to CBOE. Based on CBOE's representations, the Commission believes that CBOE had adequate facilities and resources to provide for

the trading, surveillance and data dissemination required to accommodate their acquisition of NYSE's options business.

The Commission appreciates the concerns and interests expressed by the commenters. The Commission has closely examined the critical views of the proposal expressed in the Erlich letter, particularly that the transfer is discriminatory, monopolistic, and constitutes an improper sale of options from one exchange to another. While the Transfer Agreement does provide different treatment among certain NYSE members, the Commission believes that this appropriately reflects the enhanced value that certain NYSE members (*i.e.*, options specialists) provide to the CBOE. Despite such distinctions, the Transfer Agreement, as a whole, significantly benefits a broad cross-section of NYSE options traders. The Commission also does not believe that the Transfer Agreement is monopolistic, noting that four vibrant options exchanges will remain after the transfer has been completed.<sup>14</sup> Finally, the Commission disagrees with Mr. Erlich's assertion that the Transfer Agreement constitutes an illegal sale of a "franchise" in NYSE Options. Rather, the Commission believes that the Transfer Agreement provides an appropriate vehicle for the CBOE to purchase, through an organized transaction, a trained pool of talent with experience in the trading characteristics of NYSE Options. The Commission notes that any other options exchange may, at any time, trade all or some NYSE Options. The Commission believes that CBOE is providing a viable choice for those NYSE Option traders who desire to continue conducting an options business. Given NYSE's expressed intention to terminate options trading on its Exchange, the Commission believes that the transfer of the options business to CBOE will provide NYSE Options firms with benefits otherwise potentially unavailable if the NYSE firms were to negotiate individually with the CBOE.<sup>15</sup>

Should the NYSE decide to re-enter the options business within a year of the Effective Date, it has agreed to pay

<sup>14</sup> Of the approximately 2,800 equity options currently traded, more than 660 are dually or multiply listed. Moreover, the Act does not require that an options exchange continue its operations. The NYSE has made a business decision to exit the options business, and the Act does not provide a basis to negate the decision of a marginal exchange (in the options business) to discontinue its operations.

<sup>15</sup> The Commission also notes that any NYSE Options firm always had the ability to become a member of any other options exchange and conduct an options business on that exchange.

CBOE \$500,000. The Commission believes this agreement is reasonable and does not constitute a "noncompetition" agreement between CBOE and NYSE, but instead serves to compensate CBOE for a portion of the costs associated with acquiring the NYSE's Options business and essentially refund the fee earned by the NYSE for brokering the transfer of its options business to the CBOE. Moreover, the payment amount is so small that it would not effectively serve as any deterrent to the NYSE's re-entry into trading NYSE Options.

## V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the CBOE, and in particular Section 6(b)(5).

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>16</sup> that the proposed rule change (File No. SR-CBOE-97-14) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38540; International Series Release No. 1076; File No. SR-ISCC-97-1]

### Self-Regulatory Organizations; International Securities Clearing Corporation; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Regarding the London Stock Exchange Link

April 22, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on March 21, 1997, the International Securities Clearing Corporation ("ISCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which items have been prepared primarily by ISCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested

<sup>16</sup> 15 U.S.C. 78s(b)(2).

<sup>17</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(91).