SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–38542; File No. SR–NYSE–97–05]

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Relating to the Agreement Transferring the New York Stock Exchange Options Business to the Chicago Board Options Exchange, Incorporated

April 23, 1997.

I. Introduction

On March 3, 1997, the New York Stock Exchange, Inc., (''NYSE'' 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''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change relating to the agreement transferring the NYSE's options business to the Chicago Board Options Exchange, Inc. (''CBOE''). The proposed rule change was published for comment in Securities Exchange Act Release No. 38376 (March 7, 1997), 62 FR 12671 (March 17, 1997). On April 22, 1997, NYSE amended the filing.[3] The Commission received six comment letters on the proposal.[4]

II. Description of the Proposal

The Exchange has stated that the purpose of the proposed rule change is to effect the fair and orderly transfer of the NYSE's options business to CBOE and to secure for traders and brokers who currently make their living on the Exchange's options floor an opportunity to continue their occupations at CBOE.

The Exchange and CBOE executed an agreement (''Transfer Agreement'') as of February 5, 1997 setting forth the terms and conditions by which CBOE would acquire the NYSE's options business. The effective date of the acquisition is scheduled for April 28, 1997, subject to fulfillment of conditions specified in the Transfer Agreement and approval of this proposed rule change and the parallel filing by CBOE.[5]

In accordance with the Transfer Agreement, CBOE will create and issue 75 options trading permits (''Permits''), each having a seven-year duration. Subject to limited exceptions, the Permits may not be sold, leased or transferred for a period of one year after the effective date under the transfer Agreement. The Permits will provide for trading on a new and separate trading floor at CBOE's Chicago facility. Representatives of the Exchange's options community have been provided an opportunity to participate in the design of the new trading floor, which will have services and support facilities comparable to those used on CBOE's principal options trading floor. Upon qualification pursuant to CBOE rules, Permit recipients will have (1) the right to act as broker or dealer in transferred options (i.e., options traded on NYSE and not dually listed on CBOE), as well as in options subsequently allocated to the program by CBOE; (2) the right to trade ''by order'' as principal on CBOE's principal trading facility those options dually listed on NYSE and CBOE; and (3) the right to trade ''by order'' as principal on CBOE's principal trading facility any other classes of CBOE options up to an aggregate of 20 percent of the holder's quarterly contract volume on CBOE.

In addition, each NYSE options specialist unit Permit holder will be appointed as the CBOE Designated a Primary Market-Maker (''DPM'') in its transferred specialty options. 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.

Permit holders will be deemed limited members of the CBOE, subject generally to the same obligations under the CBOE rules as are regular CBOE members, with certain exceptions. One notable exception is that application fees will be waived in certain instances. Also, under certain circumstances, recipients of Permits or their nominees who move their principal residence to Chicago and qualify under CBOE rules may receive up to $10,000 per Permit for customary moving expenses.

Each Exchange non-specialist options firm, including sole proprietors, doing business on the NYSE options floor will be offered the same number of Permits as that firm had in valid NYSE floor badges as of December 5, 1996. However, in order for the firm to actually receive Permits, the firm's individual badge holders on that date must personally qualify and trade on CBOE as individual Permit holders or as ''nominees'' of the firms owning Permits. Consistent with CBOE rules permitting partnerships and corporations to be members, the firms themselves may own Permits. CBOE may impose limits on transfers on Permits and prohibit substitutions of nominees in a manner designed to assure that Permits are not transferred, and that nominees remain with the firm at CBOE for one year after issuance.

As in the case of non-specialist firms, each Exchange specialist options firm, including joint books, will be offered the same number of Permits as that firm had in valid NYSE floor badges as of December 5, 1996. However in contrast to non-specialist firms, no specified individual will be required to be a specialist firm's nominee or to move to or remain at CBOE as a condition of a Permit's effectiveness. Instead, the specialist firms can select the persons to become nominees and use the Permits. Nominees may be freely substituted, but CBOE may impose limits on transfers of Permits designed to assure that Permits are not transferred for one year after issuance.

CBOE will lease out any of the 75 Permits not issued as specified above, as well as any Permits revoked due to violation of CBOE restrictions on transfer and substitution of nominees, through an auction or other competitive processes. The proceeds from the leases will be distributed pro rata to the approximately 92 persons who, as a result of their options trading rights (''OTR''), were entitled to possible benefits.[6]

The purchase price under the Transfer Agreement is $5,000,000. The Exchange will retain $1.2 million of the purchase price to partially offset Exchange exit

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

[2] 17 CFR 240.19b–4.

[3] Letter from James E. Buck, Senior Vice President and Secretary, NYSE to Margaret J. Blake, Special Counsel, Division of Market Regulation, Commission (April 18, 1997).

[4] Letters from Simon Erlich, Options Member, NYSE, to Jonathan G. Katz, Secretary, Commission (March 19, 1997) (''Erlich Letter''); Andrew Rothlein, Stock and Index Option Broker-Dealer, NYSE, to Jonathan G. Katz, Secretary, Commission (April 4, 1997) (''Rothlein Letter''); Isaac M. Ovadiah, G.P., to Jonathan G. Katz, Secretary, Commission (April 7, 1997) (''Ovadiah Letter''); Ernest M. Cortegiano, to Jonathan G. Katz, Secretary, Commission (April 7, 1997) (''Cortegiano Letter''); Issac M. Ovadiah, to Arthur Levitt, Chairman, Commission (April 14, 1997) (''Ovadiah Letter No. 2''); Michael Schwartz, Chairman, Committee on Options Proposals (April 8, 1997) (''COOP'' Letter).

[5] On April 23, 1997, the Commission approved the parallel CBOE filing. See Securities Exchange Act Release No. 38541 (April 23, 1997).

[6] Because there are as many OTRs as there are Exchange members (a total of 1366), but only 92 OTRs were directly involved in the options business, there was an excess of 1274 OTRs, thus complicating negotiations to obtain cost-free trading permits. Accordingly, by resolution on September 5, 1996, the Exchange's Board limited the universe of OTR holders potentially entitled to direct benefits from the transfer to present and future holders of the 92 ''activated'' OTRs, that is, to: (1) Regular members who already were using or leasing out their OTRs, (2) holders of OTRs separated from equity memberships, and (3) subsequent purchasers from them.

costs and as compensation for a ten-year license given to CBOE to list and trade options on the NYSE Composite Index. The Exchange will distribute the remaining $3.8 million of the purchase price, net of an appropriate tax reserve, on a pro rata basis to all of its 1366 members, subject to a determination of whether or not the distribution will be taxed both to the Exchange and to the member recipients. The tax reserve also includes a component designed as a precaution to address the possibility that the lease pool proceeds (discussed herein) may result in imputed income to the Exchange. The Exchange will apply to the Internal Revenue Service for Private Letter Rulings to resolve the two tax questions. Pending receipt of the rulings, CBOE will pay the $3.8 million into an Escrow Account.

If the Exchange receives an adverse ruling on the lease proceeds, a portion of the escrow account will be released annually as needed to fund tax payments, with any surplus in excess of $1000 in the escrow account after funding of any Exchange tax payments on lease pool proceeds being paid either to the NYSE Foundation [7] or pro rata to the Exchange's 1366 members.[8] If the Exchange receives an adverse ruling on the distribution to the 1366 members, distribution (net of any tax reserve for the lease pool proceeds) of some or all of the escrow account may be made to the NYSE Foundation instead of the 1366 members. Under no circumstances will escrow funds, except for amounts owed to the Exchange and any tax reserves or reserve surplus less than $1000, be distributed other than to the 1366 members or the NYSE Foundation.

The Exchange proposes to retain discretion to require payment of outstanding amounts owing to the Exchange by OTR holders through the distribution lease pool proceeds or by conditioning the receipt of Permits upon payment of outstanding debts. (See, e.g., NYSE Constitution, Article II, Section 8; NYSE Rule 795(d)(i); and NYSE Rule 795.10, Supplementary Material.) The Exchange also originally proposed to retain the discretion to require the transfer of separated OTRs to the Exchange. In its letter responding to commenters, however, the Exchange stated its intention not to exercise this discretion.[9]

III. Comments

The Commission received six comment letters in response to the filing, with one commenter submitting two letters.[10] Four commenters opposed the NYSE's transfer of its options business,[11] and one commenter favored the transfer.[12] The Exchange submitted a letter in response to those commenters in opposition to the proposal.[13]

The four opposing commenters believe the transfer is discriminatory in that it treats differently non-specialist firms that have leased their OTRs versus non-specialist firms that have not.[14] Specifically, these commenters argue that a non-specialist firm leasing out OTRs will not have the right to receive a Permit on the CBOE, while non-specialist firms that have not leased out their OTRs may receive Permits for their individual badge holders. One commenter questioned why the lessees of Permits acquire more privileges than the actual lessors.[15]

Three opposing commenters state their disagreement with the difference in treatment of specialists and non-specialists firms in the transfer.[16] These commenters argue that allowing specialist firms to designate a nominee for trading NYSE Options, while denying that benefit to non-specialist firms, is anti-competitive and unfair. One commenter argues that this will have no constructive purpose and will only serve to drive non-specialist firms out of business.[17]

Two opposing commenters question the actual subject matter of the sale.[18] One commenter questions how one exchange may sell to another exchange that which it has been granted for free (*i.e.*, the right to trade in certain options).[19] Another commenter essentially believes CBOE is purchasing exclusive listing programs for the options currently listed on CBOE and NYSE, as well as trading privileges in those options allocated to NYSE.[20]

Two opposing commenters question the validity of the lease pool.[21] They believe there is no assurance that any revenue will be generated from the lease pool.

One commenter was in favor of the proposal.[22] This commenter believes the relative size of the NYSE Options program, coupled with the NYSE's lack of automatic execution capability for options, has led to cost inefficiencies. This commenter believes that the efficiencies available at CBOE will more than off-set any potential reduction in intermarket competition.

In response to commenters, the Exchange states that the proposal is not anticompetitive or discriminatory in its treatment of specialist versus non-specialist firms, but merely reflects the premium placed on specialists as opposed to non-specialists participating in the transfer. The Exchange further states that a badge holder of a non-specialist firm can receive the benefits of a Permit so long as it contributes the attributes that CBOE believes will most enhance success in the transferred market. The Exchange states that the number of Permits negotiated were based on what the market would economically support and the desire to maximize the business opportunities created in the transferred market. The Exchange believes that the resolution is both reasonable and fair.

In response to commenters' assertions of lost or reduced OTR lease revenues as a result of the sale, the Exchange notes that, subject to certain contingencies, OTR owners will receive, for seven years, payments from the CBOE lease pool that are anticipated to substantially exceed typical lease payments now received for OTRs. Moreover, the Exchange states that had it simply ceased operation of its options business without transferring it to CBOE, OTR lessors would thereafter have received no lease payments of any kind.

The Exchange states that the proposal is not monopolistic or an unlawful circumvention of Commission policy on dual listing of options. The Exchange states that it has no agreement with CBOE to restrict dual listings of options

[7] The NYSE Foundation, authorized by the Board of Directors of the Exchange in October 1983 and incorporated as a not-for-profit organization in November 1983, provides funds for educational, civic and charitable purposes. The Foundation's charitable giving focuses on three main areas: education, quality of life, and community. The escrow funds would be available for any such purposes other than those specifically targeted at the securities industry.

[8] See supra note 3. As originally filed, any surplus remaining in escrow after tax payments on the lease pool proceeds would revert to the Exchange's treasury. The amendment states that any surplus, in excess of $1000, of reserve tax funds remaining in the escrow account after tax payments on lease pool proceeds will be paid either to the NYSE Foundation or pro rata to the Exchange's 1366 members.

[9] See NYSE Letter.

[10] See supra note 4.

[11] See Erlich Letter; Rothlein Letter; Ovadiah Letter (April 4, 1997); Cortegiano Letter; Ovadiah Letter No. 2 (April 10, 1997).

[12] See COOP Letter.

[13] Letter from Richard P. Bernard, Executive Vice President and General Counsel, NYSE, to Michael A. Walinskas, Senior Special Counsel, Division of Market Regulation, Commission (April 21, 1997) (''NYSE Letter'').

[14] See Erlich Letter; Rothlein Letter; Ovadiah Letter (April 4, 1997); Cortegiano Letter.

[15] See Ovadiah Letter (April 4, 1997).

[16] See Erlich Letter; Ovadiah Letter (April 4, 1997); Cortegiano Letter.

[17] See Cortegiano Letter.

[18] See Erlich Letter; Cortegiano Letter.

[19] See Erlich Letter.

[20] See Cortegiano Letter.

[21] See Ovadiah Letter; Cortegiano Letter.

[22] COOP Letter.

or to restrict, monopolize or foreclose any market. Furthermore, the Exchange notes that the agreement with CBOE does not contain a covenant not to compete. The Exchange has agreed to pay $500,000 to CBOE if, within one year of the Effective Date, NYSE determines to reenter the options business. According to NYSE, this payment acts as a one-time ''benefit of the bargain'' payment to CBOE.

Finally, the Exchange notes that the value of the transfer of the Exchange's options business was determined by competitive bids in a free and open market setting.

IV. Discussion

The Commission believes NYSE's proposal is consistent with the requirements of Section 6(b)(5) of the Act.[23] 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.

Early last year, the NYSE conducted a strategic review of the 13-year operation of its options business. In the course of the review, the Exchange considered the potential for overall growth in the options industry, explored the needs of the order-providing firms and the relationships through which the options business is done, assessed the existing capacity and structure in the options industry and the Exchange's existing and potential competitive position, and examined the scale of the effort necessary to make the Exchange's options business line profitable. The Exchange concluded that remaining in the options business, even at the then-current market share, would require significant capital expenditures, and that any effort to significantly improve market share would require an enormous expenditure of capital and human resources. After analyzing its strategic review, the NYSE determined that it was in the best interest of its members that the options business be transferred elsewhere rather than terminated. The Transfer Agreement between NYSE and the CBOE represents the culmination of NYSE's efforts to transfer the options business.

Based on the representations of the NYSE, and after review of the proposed filing and submitted comment letters, the Commission has determined the Exchange's proposal is consistent with the overall public interest. The Exchange conducted a careful assessments and review of its options business and determined that it no longer wished to continue this business. There is nothing in the Act that compels the NYSE to continue to trade a particular product line. Moreover, the NYSE is permitted to terminate the options business entirely (consistent with an orderly wind-down of existing positions). Rather than simply terminate its options business, the NYSE attempted to package its options business as a whole and attempted to transfer it to another exchange in return for certain privileges accruing to NYSE options members and consideration paid to NYSE members. This not only facilitated the transfer of a talent pool to the CBOE, but also directly benefited NYSE members.

According to the Exchange, it chose CBOE from among those exchanges showing interest in the transfer because opportunities for traders were best at CBOE. Furthermore, the CBOE bid was selected through an open and competitive process, with NYSE determining that the CBOE bid was superior both from a financial perspective, and in terms of the opportunity it promised NYSE Options traders and brokers to continue making their living in the options business. The Commission recognizes that the transfer may create hardships for some existing NYSE members. However, the Commission believes that the NYSE has made reasonable efforts to achieve a solution that has maximized the value of the NYSE Options program. Particularly, given the available alternative to the NYSE of terminating the business altogether, the Commission believes the transfer provides additional opportunities for NYSE options traders and brokers that the NYSE was under no obligation to provide under the federal securities laws.

In response to commenters concerns regarding the disparity in the treatment of specialist firms versus non-specialist firms, the Commission believes that such differential treatment is justified given the available alternatives. As noted by the Exchange, the elements of the transfer outlined above represent a series of pragmatic compromises negotiated to reconcile the respective goals of the Exchange and CBOE. NYSE sought to minimize the disruption in the lives of the option badge holders and to maximize the opportunity for its options traders and brokers to continue to make their living in the options business after the transfer.

CBOE sought to maximize the success of the transferred market as a whole by seeking to assure (1) that the NYSE Options specialists participated in the transfer, (2) that NYSE Option traders and brokers with trading experience moved to Chicago, and (3) that the number of Permits issued optimized the viability of the transferred market as a whole and of the businesses of the Permit holders individually. Thus the Transfer Agreement's ''homesteader'' element was designed to support CBOE's general goal of attracting experienced traders. However, the omission of a homesteading requirement for specialists reflects the higher priority attached by CBOE to assuring that all of the options specialists participated in the transfer. The terms of the business agreement negotiated and agreed to by the NYSE and CBOE do not appear inconsistent with the federal securities laws.

The Commission believes that the Transfer Agreement's provision for specialists to designate a nominee constitutes a reasonable method to encourage specialist firms to participate in the transfer. The difference in treatment between the specialist and non-specialist firms recognizes their largely disparate backgrounds, rights, duties and functions. 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 CBOE to grant them more flexible Permits than other NYSE Option members.

The Transfer Agreement also provides for differing treatment among OTR holders. Given the large number of OTR holders, the Exchange recognized the need to narrow the group eligible for Permits based on activity and expertise in trading of NYSE Options. In this regard, the proposal attempts to create an incentive to those individuals who actively trade NYSE Options (*i.e.*, badge holders) to continue their options business at CBOE. Some commenters opposed this incentive, noting it unjustly benefits lessees of OTRs over non-specialist firm lessors. given the large number of outstanding OTRs, however, the Commission believes it was reasonable for the Exchange to limit the number of Permits issued in order to achieve an economically beneficial transfer of the NYSE Options business. The Exchange made a determination that the transferred market would economically support only a limited number of Permits. Therefore, the Permits were distributed in a way designed to maximize business opportunities created in the transferred

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

market, based on its determination that non-specialist OTR lessors are less likely to have the knowledge and proficiency of their lessees in trading NYSE Options.

However, the Exchange did not intend to penalize the lessors, and in an effect to compensate these OTR holders, it created the lease pool concept, from which the lessors will receive direct benefits from leasing of excess Permits. As the NYSE noted, its anticipates, given certain contingencies, that payments from the lease pool will exceed lease payments now received for OTRs. Accordingly, the Commission believes that the established limit on Permits, the manner in which they are to be distributed, and the lease pool program, are all reasonable provisions contained in the Transfer Agreement. By limiting Permits to experienced NYSE Options traders, the Commission believes the Exchange's goal of transferring a pool of trained experts in NYSE Options is more likely to be met.

Some commenters questioned the validity of the transfer and believe it is noting more than the purchase of trading rights in NYSE-listed options. The Commission would regard any anticompetitive arrangements in the trading of options to be of very serious concern, but after reviewing the proposed transfer closely, the Commission disagrees with these assertions. As the Exchange noted in its letter responding to commenters,[24] there is no agreement between NYSE or CBOE to restrict dual listing of options or to restrict, monopolize or foreclose any market. The Commission believes that the proposal 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.[25] The Commission notes that any other options exchange may, at any time, trade all or some NYSE Options. Furthermore, the Commission believes that the transfer provides a viable choice of these NYSE Options 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 individual with the CBOE.[26]

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

Commenters questioned whether any revenue would be generated from the lease pool. The Commission believes, based on the representations of the Exchange, that the proceeds from the lease pool may substantially exceed typical lease payment now received for OTRs. The Commission notes that if the Exchange had determined to cease operation of its options business, OTR lessors would have received no lease payment of any kind. In this regard, the Commission believes the creation of a lease pool for distribution of lease proceeds is equitable.

The Exchange, pursuant to its Constitution and rules, retains the discretion to require payment of outstanding amounts owing to the Exchange by conditioning the receipt of Permits thereon, or through the distribution of lease pool proceeds.[27] The Commission believes such discretion is reasonable as it will assure the Exchange that upon the transfer of OTRs, outstanding debts to the Exchange will be settled. The Commission believes this is reasonable and will not affect the substantive rights of OTR holders as the provision is currently applied for the transfer of OTRs.

The Commission finds good cause to approve Amendment No. 1 to the filing prior to the 30th day after the date of publication of the notice of filing because the Amendment does not affect the substantive rights of the members and accelerated approval will facilitate the uninterrupted transfer of the NYSE Options business to CBOE as scheduled.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1. Persons making written submission should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington DC 20549. Copies of the submissions, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule changes 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 at the Commission's Public Reference Section, 450 5th Street, NW., Washington, DC 20549. Copies of such filings will also be available at the principal office of the Exchange. All submissions should refer to File No. SR–NYSE–97–05 and should be submitted by May 21, 1997.

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change and Amendment No. 1 are consistent with the Act and the rules and regulations thereunder applicable to the NYSE, and in particular Section 6(b)(5).

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[28] that the proposed rule change (File No. SR–NYSE–97–05) be and hereby is approved, and that Amendment No. 1 filed thereto be and hereby is approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[29]

Margaret H. McFarland,

Deputy Secretary.

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[24] See NYSE Letter.

[25] The fee paid by the CBOE also reflects, in part, the ten-year license granted to CBOE to enable it to trade NYA Options.

[26] 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.

[27] NYSE Constitution, Article II, Section 8; NYSE rule 795(d)(i); and NYSE Rule 795.10, Supplementary Material.

[28] 15 U.S.C. 78s(b)(2).

[29] 17 CFR 200.30–3(a)(12).

SMALL BUSINESS ADMINISTRATION

Reporting and Recordkeeping Requirements Under OMB Review

ACTION: Notice of Reporting Requirements Submitted for Review.

SUMMARY: Under the provisions of the Paperwork Reduction Act (44 U.S.C. Chapter 35), agencies are required to submit proposed reporting and recordkeeping requirements to OMB for review and approval, and to publish a notice in the **Federal Register** notifying the public that the agency has made such a submission.