

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

The foregoing rule change has become effective immediately pursuant to Section 19(b)(3)(a)(iii)<sup>10</sup> of the Act and subparagraph (f) of Rule 19b-4 thereunder<sup>11</sup> because it is concerned solely with the administration of the Exchange.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>12</sup>

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, 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. Copies of such filing will also be available for inspection and copying at the principal office of the PCX. All submissions should refer to File No. SR-PCX-99-23 and should be submitted by July 30, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41588; File No. SR-Phlx-98-56]

#### Self-Regulatory Organizations; Philadelphia Stock Exchange Inc.; Order Approving Proposed Rule Change Relating to the Enhanced Parity Split Pilot Program for Equity and Index Option Specialists, and the Adoption of an Enhanced Parity Split for Specialists That Develop and Trade New Products

July 1, 1999.

#### I. Introduction

On December 28, 1998, the Philadelphia Stock Exchange, Inc. ("Exchange" or "Phlx") submitted to the Securities and Exchange Commission ("Commission"), 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 seeking to extend and receive permanent approval of the Exchange's enhanced parity split pilot program for Exchange specialists in equity and index options ("Pilot Program").<sup>3</sup> In addition, the Exchange proposed to amend Exchange Rule 1014(g), "Equity Option and Index Option Priority and Parity," and its corollary Option Floor Procedure Advice B-6 to provide an enhanced parity split for Exchange specialists that develop and trade new products.

In the release published for comment in the **Federal Register** on January 12, 1999, the Commission gave accelerated approval to the Exchange's request that the Pilot Program be extended for a six-month period ending June 30, 1999, or until the Commission approves the Exchange's request for permanent approval of the Pilot Program, whichever occurred first.<sup>4</sup> The Commission did not receive any comment letters with respect to the proposal. This order permanently approves the Pilot Program and the Exchange's proposal to establish an enhanced parity split for Exchange specialists that develop and trade new products.

### II. Description of the Proposal

#### A. Permanent Approval of the Pilot Program

The Exchange seeks permanent approval of the Pilot Program for Exchange specialists in equity and index options. The Commission first approved the Pilot Program on August 26, 1994,<sup>5</sup> to provide Exchange specialists in equity options with an enhanced participation in "parity trades," or trades where orders compete at the same price.<sup>6</sup> While a parity trade is generally divided evenly among the crowd participants on parity, the enhanced participation gives the specialist a greater share of the trade than he would normally receive.

On November 30, 1994, the Commission approved the Exchange's proposal to expand the Pilot Program to include index option specialists.<sup>7</sup> The Pilot Program was later revised on March 1, 1995, with respect to situations where less than three controlled accounts are on parity with the specialist.<sup>8</sup> The Pilot Program was subsequently renewed without change on three occasions<sup>9</sup> and later was extended and expanded so that the enhanced parity split applies to: (i) All index options; (ii) all new option classes allocated to a specialist during the year; and (iii) 50% of a specialist's equity option issues, which issues are designed by the specialist and approved by the Exchange's Allocation, Evaluation, and Securities Committee.<sup>10</sup> In addition, the Pilot Program was revised to permit specialists to revise the list of eligible

<sup>5</sup> See Securities Exchange Act Release No. 34606 (Aug. 26, 1994), 59 FR 45741 (Sep. 2, 1994). The Pilot Program was initially approved for a one year period ending August 26, 1995.

<sup>6</sup> According to Exchange Rules 119 and 120, when bids and offers are made simultaneously, or when it is impossible to determine clearly the order of time in which they were made, all such bids and offers shall be on parity. For example, suppose that a floor broker holding a sell order for 10 Jan XYZ call options announces his order to the crowd. In response, three crowd participants might simultaneously bid to buy the 10 Jan XYZ call options at the same price. Because these three simultaneous bids are competing at the same price, the bids are on parity.

<sup>7</sup> Securities Exchange Act Release No. 35028 (Nov. 30, 1994), 59 FR 63151 (Dec. 7, 1994).

<sup>8</sup> Securities Exchange Act Release No. 35429 (Mar. 1, 1995), 60 FR 12802 (Mar. 8, 1995).

<sup>9</sup> Securities Exchange Act Release Nos. 36122 (Aug. 18, 1995), 60 FR 44530 (Aug. 28, 1995); 37524 (Aug. 5, 1996), 61 FR 42080 (Aug. 13, 1996); and 38924 (Aug. 11, 1997), 62 FR 44160 (Aug. 19, 1997).

<sup>10</sup> Securities Exchange Act Release No. 39401 (Dec. 4, 1997), 62 FR 65300 (Dec. 11, 1997). The Exchange maintains a separate, permanent enhanced parity split program for new specialist units that trade newly listed options. See Exchange Rule 1014(g)(iii), "New Unit/New Option Enhanced Specialist Participation," and Securities Exchange Act Release No. 34109 (May 25, 1994), 59 FR 28570 (June 2, 1994).

<sup>10</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>11</sup> 17 CFR 240.19b-4(f).

<sup>12</sup> In reviewing this proposal, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See Exchange Rule 1014(g)(ii), "Two for-one Enhanced Specialist Participation."

<sup>4</sup> Securities Exchange Act Release No. 40876 (Dec. 31, 1998), 64 FR 1849 (Jan. 12, 1999).

options (*i.e.*, the designated equity options for which the specialist is entitled to receive the enhanced parity split) on a quarterly basis, rather than annually.

The Exchange now seeks permanent approval of the Pilot Program. The Pilot Program works as follows: when an equity or index option specialist is on parity with one controlled account<sup>11</sup> and an order for more than five contracts comes into the crowd, the specialist will receive 60% of the contracts and the controlled account will receive 40%. When the specialist is on parity with two controlled accounts and the order is for more than five contracts, the specialist will receive 40% of the contracts and each controlled account will receive 30%. When the specialist is on parity with three or more controlled accounts and the order is for more than five contracts, the specialist will be counted as two crowd participants when allocating the contracts. In any of these situations, if a customer order is on parity, the customer will not be disadvantaged by receiving a lesser allotment than any other crowd participant, including the specialist. Thus, a customer on parity is assured a minimum participation that is equal to the participation of the specialist.<sup>12</sup>

The application of this enhanced parity split is mandatory. Therefore, with respect to any equity or index option transaction that implicates the enhanced parity split, the specialist is required to accept the preferential allocation and may not decline the enhancement. If an equity or index option trade is on parity, but not subject to the enhanced parity split (*i.e.*, the trade is for five or less contracts), the Exchange specialist is required to allocate the contracts according to the Exchange's priority and parity rules.<sup>13</sup>

At the request of the Commission, the Exchange prepared a report ("Report") discussing whether the: (i) Pilot Program has generated any evidence of any adverse effect on competition or investors, in particular, or the market for equity or index options, in general; (ii) Exchange has received any complaints,

either written or otherwise, concerning the operation of the Pilot Program; and (iii) Exchange has taken any disciplinary action against, or commenced any investigations, examinations, or inquires concerning the operation of the Pilot Program, as well as the outcome of any such matter.

The Exchange incorporated the findings of its Report into the proposed rule change filing. According to the Exchange, its regulatory personnel have not observed during the past year evidence of any adverse effects on competition, investors, or the market for equity or index options. As to the second issue, the Exchange has not received any complaints, either orally or in writing, from investors or Exchange members regarding the Pilot Program. Finally, regarding disciplinary actions, investigations, examinations or inquires, the Exchange reports that it did not commence any investigations relating to the Pilot Program this past year.

#### *B. Adoption of Enhanced Parity Split for Specialists That Develop and Trade New Products*

The Exchange separately proposes to adopt an enhanced parity split for Exchange specialists that develop and trade new products ("New Products Split"). The Exchange stated that the New Products Split is intended to encourage specialist units to develop and trade new products, and to provide liquidity in such products, thereby attracting order flow to the Exchange. The exchange believes that the proposal balances the competing interests of specialists and Registered Option Traders ("ROT's"), while encouraging specialists to take an active role in supporting and marketing a new product, both important activities in a competitive environment.

Under the proposed New Products Split, when the specialist is on parity with three or more controlled accounts in the crowd, the specialist will receive 40% of the contracts and the controlled accounts will receive the remaining 60%. When the specialist is on parity with less than three controlled accounts in the crowd, the specialist will receive 60% of the contracts and the controlled accounts will receive 40%. In either of these situations, if a customer order is on parity, the customer may not receive a lesser allotment than any other crowd participant, including the specialist.

The Exchange indicated that the New Products Split would be limited to new products developed and traded by the same specialist unit. Therefore, if one specialist unit develops a new product but another specialist unit is allocated specialist privileges in that same new

product,<sup>14</sup> the specialist unit trading the new product would not be entitled to the New Products Split. The Exchange's Options Committee will be responsible for determining whether a specialist "developed" a new product.

### **III. Discussion**

For the reasons discussed below, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange. In particular, the Commission believes the proposed rule change is consistent with the Section 6(b)(5)<sup>15</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, and protect investors and the public interest.<sup>16</sup> The Commission also finds that the proposal may serve to remove impediments to and perfect the mechanism of a free and open market by helping the Exchange to attract and retain specialist units, and offer new products to the investing public.

Generally, a parity trade is divided evenly among the crowd participants on parity. However, the Pilot Program and the New Products Split would provide Exchange specialists with an enhanced participation in parity trades. The enhancement would give the specialist a greater share of the trade than he would normally receive.

The Pilot Program gives an equity or index option specialist 60% of the contracts when he is on parity with one controlled accounts and the order is for more than five contracts. When the specialist is on parity with two controlled accounts and the order is for more than five contracts, the specialist will receive 40% of the contracts. When the specialist is on parity with three or more controlled accounts and the order is for more than five contracts, the specialist will be counted as two crowd participants when allocating the contracts.

The New Products Split would give an eligible specialist (*i.e.*, a specialist who developed a new product and to whom the new product is allocated) 40% of the contracts in the new product when the specialist is on parity with three or more controlled accounts in the crowd. When the specialist is on parity with less than three controlled accounts

<sup>11</sup> A controlled account is defined as "any account controlled by or under common control with a member broker-dealer." Customer accounts, which include discretionary accounts, as defined as all accounts other than controlled accounts. See Exchange Rule 1014(g)(i).

<sup>12</sup> For example, if a customer is on parity with a specialist and two controlled accounts for a 10 contract order, the specialist—and therefore the customer also—would be entitled to receive 4 contracts (40%).

<sup>13</sup> See Exchange Rule 119, "Precedence of Highest Bid," and Exchange Rule 120, "Precedence of Offers at Same Price."

<sup>14</sup> Allocation determinations are governed by Exchange Rules 500–526.

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

<sup>16</sup> In approving this proposed rule change, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

in the crowd, the specialist will receive 60% of the contracts. Under the Pilot Program and the New Products Split, if a customer order also is on parity, the customer may not receive a lesser allotment than any other crowd participant, including the specialist.

The Commission recognizes that the purpose of the enhanced parity split is to encourage specialists to make deep and liquid markets in order to attract order flow to the Exchange. The Commission has previously noted that specialists have responsibilities that other crowd participants do not share, such as the staff costs associated with continually updating and disseminating quotes.<sup>17</sup> As a result, the Commission believes it is reasonable for the Exchange to grant certain advantages to specialists, such as the enhanced parity split, to attract and retain well capitalized specialists at the Exchange. As long as these advantages do not unreasonably restrain competition and do not harm investors, the Commission believes that the granting of such benefits to specialists, in general, is within the business judgment of the Exchange.

The Commission believes that the proposal will encourage specialists to make deep and liquid markets to attract order flow to the Exchange. The Commission also believes that the Pilot Program and New Products Split provide reasonable benefits to specialists, given the heightened responsibilities and costs of specialist. Because it appears that these that these benefits do not unreasonably restrain competition and do not harm investors, the Commission believes that the approval of the Pilot Program and New Products Split is consistent with the Act.

The Pilot Program and the New Products Split specify that the application of the enhanced parity split cannot cause a customer order on parity to received a smaller participation than any other crowd participant, including the specialist. The Commission believes this provision adequately protects customers orders from any negative impact that might flow from application of the enhanced parity split. As a result, customer orders on parity are ensured a participation that, at a minimum, is equal to that given any other crowd participant on parity.

The Commission notes that the Pilot Program has been operative, albeit in differing forms, since 1994. During that period, the Commission has required the Exchange to submit Reports

discussing: (i) The Pilot Program's impact on competition and investors; (ii) complaints regarding the Pilot Program; and (iii) inquiries, investigations, or disciplinary actions taken regarding the Pilot Program. The Reports have indicated that the Pilot Program operates well and does not adversely impact competition or investors.<sup>18</sup> Furthermore, the Exchange has not received complaints regarding the Pilot Program and has brought only one disciplinary action concerning the Pilot Program.<sup>19</sup> The Commission believes that the absence of significant problems over the past five years demonstrates that the Pilot Program is a reasonable benefit for the Exchange to offer to its equity and index option specialists.

Based on the Exchange's five year experience with the Pilot Program, and the similarity between the Pilot Program and the New Products Split, the Commission believes that the New Products Split is a reasonable measure to attract new products to the Exchange. Like the Pilot Program, the New Products Split should be an incentive for Exchange specialists to generate more business by developing and training new products. The Commission supports the Exchange's attempts to attract new business. The Commission also believes that because the enhanced parity split will be available only to a specialist unit that develops and trades a new product, the benefit is reasonably limited in scope to those specialist units that put forth significant effort. Therefore, the Commission believes it is appropriate to approve the New Products Split.

#### IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>20</sup> that the proposed rule change (SR-Phlx-98-56) is approved.

<sup>18</sup> The Exchange found that the enhanced parity split, as first proposed in 1994, was overly burdensome when only one or two controlled accounts were on parity with the specialist. Therefore, the Exchange amended the Pilot Program in 1995 to make the enhanced parity split more equitable in those situations. See Securities Exchange Act Release No. 35429 (Mar. 1, 1995), 60 FR 12802 (Mar. 8, 1995). The Exchange also formed a subcommittee to analyze the Pilot Program and its effect on competition, investors, and the market in general. The subcommittee members concluded that there is no evidence of any adverse effects on competition, investors, or the market for equity or index options.

<sup>19</sup> In 1995, the Exchange brought one disciplinary case against an equity option specialist for making an inequitable split among himself and the ROTs in the crowd. The specialist was censured and suspended for one week as part of a settlement. See Exchange Enforcement Matter No. 95-12.

<sup>20</sup> U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

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

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41591; File No. SR-Phlx-99-17]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. to Amend By-Law Article IX—Trustees of Stock Exchange Fund, at Section 9-5—Agent of Trustees, and Section 9-6—Reports

July 1, 1999.

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> notice is hereby given that on June 9, 1999, the Philadelphia Stock Exchange, Inc. ("PHLX" 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 Exchange. 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 seeks to amend By-Law Article IX—Trustees of Stock Exchange Fund, at Section 9-5—Agent of Trustees, and Section 9-6—Reports. The text of the proposed rule change is set forth below. Additions are italicized, and deletions are bracketed.

\* \* \*

By-Law Article IX

Trustees of Stock Exchange Fund

\* \* \*

Agent of Trustees

Section 9-5. The Trustees shall, with approval of the Board of Governors, appoint an [Trust Company to act as their] Agent, to hold the securities of the Exchange for safekeeping, to collect the interest, dividends and income therefrom for the Treasurer of the Exchange. Said Agent shall also, from time to time, make deliveries of securities held for the Trustees of the Stock Exchange Fund as the Trustees of the Stock Exchange Fund shall direct.

<sup>21</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>17</sup> See, e.g. Securities Exchange Act Release No. 35177 (Dec. 29, 1994), 60 FR 2419 (Jan. 9, 1995).