SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45313; File No. SR–PCX–2002–03]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change by Pacific Exchange, Inc. To Increase Position and Exercise Limits for Nasdaq-100 Index Tracking Stock Options

January 18, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934,[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 17, 2002, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') 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 by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

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

The PCX proposes to increase position and exercise limits for Nasdaq-100 Index Tracking Stock (''QQQ'') options to 300,000 contracts on the same side of the market.[3] The text of the proposed rule change is available at the Office of the Secretary, PCX, and at the Commission.

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 PCX 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 III below. The PCX has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

[2] 17 CFR 240.19b–4.

[3] The PCX also proposed a non-substantive amendment to Rule 6.9(a) clarifying that options on securities such as unit investment trusts must follow equity position and exercise limit rules.

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

1. Purpose

The Exchange is proposing to increase position and exercise limits for QQQ options up to 300,000 contracts on the same side of the market. The Exchange will continue to require that member organizations report all QQQ options positions exceeding 200 contracts pursuant to Exchange Rule 6.6. Moreover, for accounts holding positions in excess of 10,000 contracts on the same side of the market, the Exchange will also continue to require information concerning the extent to which such positions are hedged. The PCX believes that increasing position and exercise limits from 75,000 to 300,000 contracts for QQQ options will provide greater flexibility for market participants attempting to hedge their market risks.[4] In addition, Exchange staff will be able to re-focus efforts and resources to other notable areas.

Manipulation

Position limits restrict the number of options contracts that an investor, or a group of investors acting in concert, may own or control. Similarly, exercise limits prohibit the exercise of more than specified a number of contracts on a particular instrument within five (5) business days. The Commission, by imposing these limits on exchange-traded options, has sought to: (1) Minimize the potential for mini-manipulations,[5] as well as other forms of market manipulations; (2) impose a ceiling on the position that an investor with inside corporate or market information can establish; and (3) reduce the possibility of disruption in the options and underlying cash markets.[6] The PCX believes that the structure of the QQQ option and the tremendous liquidity of both the underlying cash and options market for QQQs should allay regulatory concerns of potential manipulation. The PCX further believes that QQQ options are not readily susceptible to manipulation based largely on the liquidity and activity of the underlying QQQ as well as the securities comprising the QQQ. Therefore, the Exchange submits that increasing position and exercise limits to 300,000 contracts may generate greater order flow for the PCX and provide members with greater flexibility in fulfilling their obligations to customers and the market.

Although the QQQ option is not itself an index option product, it nonetheless is designed to closely track the price and yield performance of the Nasdaq-100 index.[7] Therefore, the PCX believes that in evaluating this proposal to increase position and exercise limits for QQQ options, the Commission should apply an analysis similar to what was used in connection with broadbased index options.[8]

The PCX believes in connection with QQQ options that the restrictive

[4] Although the current position limit is 75,000 contracts due to a 50% reduction in the value of the underlying QQQ on March 20, 2000, the limit was adjusted to 150,000.

[5] Mini-manipulation is an attempt to influence, over a relatively small range, the price movement in a stock to benefit a previously established options position.

[6] *See* Becker and Burns, Regulation of Exchange-Traded Options in *The Handbook of Derivatives and Synthetics* (1994), Probus Publishing Company, and Regulating the Options Market, *Institutional Investor Forum* (November 1991).

[7] QQQ represents ownership in the Nasdaq-100 Trust, a long-term unit investment trust established to accumulate and hold a portfolio of the equity securities that comprise the Nasdaq-100 Index. The Nasdaq-100 Index includes 100 of the largest non-financial companies listed on the Nasdaq National Market. The Nasdaq-100 reflects Nasdaq's largest growth companies across major industry groups with all index components having a market capitalization of at least $500 million and an average daily trading volume of at 100,000 shares. QQQ is intended to provide investment results that generally correspond to the Nasdaq-100 Index with an initial market value approximated at 1/40th the value of the underlying Nasdaq-100 Index. A description and analysis of the Nasdaq-100 Index is set forth by the Commission in Securities Exchange Act Release No. 33428 (January 4, 1994), 59 FR 1576 (January 11, 1994) (order approving trading of Nasdaq-100 options by the CBOE). As of November 30, 2001, the market capitalization of the securities underlying the Nasdaq-100 Index was approximately $1.875 trillion, while the QQQ had net assets of $23.96 billion and 559.1 million shares outstanding. By far the largest economic sector represented is technology amounting to 68.91%. The top QQQ holding is Microsoft, accounting, for 11.97% while the top ten holdings constitute 43.22%.

[8] *See* Securities Exchange Act Release Nos. 41011 (February 1, 1999), 64 FR 6405 (February 9, 1999) (order approving the elimination of position and exercise limits for XMI and XII options on a two-year pilot basis) and 40969 (January 22, 1999), 64 FR 4911 (February 1, 1999) (order approving the elimination of position and exercise limits for SPX, OEX, DJX and related FLEX options on a two-year pilot basis).

The Commission notes that the elimination of position and exercise limits for certain broad-based index options was based on many factors including the enormous capitalization's of the indexes. For example, the market capitalization of the SPX, OEX and DJX as of October 2001 was $9.81 trillion, $5.7 trillion and $3.23 trillion, respectively. *See* Securities Exchange Act Release No. 44994 (October 26, 2001) 66 FR 55722 (November 2, 2001) (permanently approving the pilot to eliminate position and exercise limits for OEX, SPX and DJX Index options). In contrast, the market capitalization of the NASDAQ 100 as of November 2001 was 1.875 trillion. The Commission further notes that options on QQQs physically settle in the underlying QQQs, which had net assets of $23.96 billion as of November 30, 2001. In contrast, index options are cash settled based on the underlying value of the index.

position and exercise limits no longer serve their stated purpose. The Commission has stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.[9]

The Exchange believes that both the size and breadth of the market for QQQs dispels concerns regarding market manipulation and disruption. The average daily trading volumes for the QQQs and QQQ options from January 1, 2001 to November 30, 2001 were 71.21 million shares and 148,181 contracts, respectively. The QQQ option is by far the most actively-traded option product in the U.S., and therefore, the most liquid. The underlying QQQ is the most actively-traded equity security in the U.S. with greater trading volume than both Microsoft and Intel.[10] Accordingly, the Exchange believes that the liquidity of the QQQ option and the underlying cash market for QQQs greatly reduces the potential for manipulations in both the options and underlying cash market.

To date, there has not been a single disciplinary action involving manipulation or potential manipulation in the QQQ or the QQQ option on the Exchange. The PCX further believes that its extensive experience conducting surveillance of derivative products and program trading activity is sufficient to identify improper activity. Routine oversight inspections of the PCX's regulatory programs by the Commission should uncover any inconsistencies or shortcomings in the manner in which derivative and options surveillance is conducted. These procedures entail a daily monitoring of market movements via automated surveillance techniques to identify unusual activity in both the options and underlying cash markets.

Competition

The Commission has stated that "limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market-makers from adequately meeting their obligations to maintain a fair and orderly market." [11] Based on the large trading volume apparent in both the underlying QQQ and QQQ options, the Exchange believes that current position and exercise limits of the QQQ option are too restrictive and may adversely affect the PCX's ability to compete with the OTC market. The Exchange believes that investors who trade listed options on the QQQ at the Exchange may be placed at a serious disadvantage in comparison to certain Nasdaq-100 index derivative products traded in the OTC market where some index-based derivatives are not currently subject to position and exercise limits.[12] Member firms also continue to express their concern that position limits on popular, actively-traded products, such as QQQ options, are an impediment to business development on the Exchange. Accordingly, a portion of this business is believed to have moved to the OTC market where some index-based derivative products are not subject to position limit requirements. In addition, the PCX believes that current base limits for the QQQ option may not be adequate in many instances for the hedging needs of certain institutions, which engage in trading strategies differing from those covered under the current index hedge exemption policy (*e.g.,* delta hedges; OTC vs listed hedges).[13]

Financial Requirements

The Exchange believes that financial requirements imposed by the Exchange and by the Commission adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in QQQ options. Current margin, and risk-based haircut methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. It should also be noted that the Exchange has the authority under PCX Rules 2.16 and 6.8 to impose a higher margin requirement upon the member or member organization when the Exchange determines a higher requirement is warranted.

Reporting Requirements

Consistent with PCX Rule 6.6, the PCX will continue to require that each member or member organization that maintains a position on the same side of the market in excess of 10,000 contracts in the QQQ option, for its own account or for the account of a customer report certain information. This data includes, but is not limited to, the option position, whether such position is hedged and if so, a description of the hedge and if applicable, the collateral used to carry the position. Exchange market-makers are exempt from this reporting requirement as market-maker information can be accessed through the Exchange's market surveillance systems. Once the 10,000 contract reporting threshold is attained, the PCX will require members and member organizations to similarly report each increase of 2,500 contracts on the same side of the market for customer accounts and each increase of 5,000 contracts on the same side of the market for proprietary accounts. The Exchange believes that the reporting level of 10,000 contracts on the same side of the market for members other than Exchange market-makers is consistent with the designation of the QQQ as an equity option, and therefore, the existing regulatory regime. Pursuant to PCX Rule 6.6, the general reporting requirement for customer accounts that maintain a position in excess of 200 contracts will remain at this level for QQQ options. Lastly, the Phlx believes that the 10,000 contract reporting requirements is above and beyond what is currently required in the OTC market. According to the Exchange, NASD member firms are only required to report options positions in excess of 200 contracts and are not required to report any related hedging information.

2. Basis

The Exchange believes that the proposed rule change is consistent with

[9] Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998).

[10] For the period of January 1, 2001 to November 30, 2001, Microsoft and Intel had average daily trading volumes of 39.38 and 53.98 million shares, respectively, compared to the QQQ with an average daily trading volume of 71.21 million shares.

[11] *See* H.R. Rep. No. IFC–3, 96th Cong., 1st Sess. At 189–91 (Comm. Print 1978).

[12] The Commission notes, however, that as an equity product, options on the QQQ are subject to position limits in the OTC market. *See* NASD Rule 2860.

[13] The current limit for QQQ options is 150,000 contracts due to the 50% reduction in the underlying value of the QQQ that occurred on March 20, 2000. At this limit, the QQQ options equate to 15,000,000 QQQ shares or an aggregate value of $59.47 billion as of November 30, 2001. At the time of approval of QQQ options, position and exercise limits were set at 25,000 (250,000 QQQ shares) equating to an aggregate value of $2,500,000 as of March 9, 1999 (commencement of trading). When QQQs commenced trading, the volume was 10.4 million shares with an opening price of $100.00 per share. The average daily trading volumes for the QQQ during 1999, 2000 and year-to-day 2001 were 13.9 million, 30.9 million and 71.21 million shares respectively, while for the same periods the average daily trading contract volume for the QQQ option were 9,206, 91,656, and 148,181. As of November 30, 2001, the price of a single QQQ was $39.65.

Section 6(b) of the Act [14] in general and furthers the objectives of Section 6(b)(5) [15] in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect and mechanism of a free and open market and a national market system, to protect investors and the public interest and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange 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

No written comments were solicited or received with respect to the proposed rule change.

III. 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 Section. Copies of such filing will also be available for inspection and copying at the principal office of the PCX. All submissions should refer File No. SR–PCS–2002–03 and should be submitted by February 15, 2002.

[14] 15 U.S.C. 78f(b).

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

IV. Commissions Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission believes the proposal is consistent with the requirements of Section 6(b)(5) of the Act [16] in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set position and exercise limits. The Commission has recognize that the limits must be sufficient to prevent investors from disrupting the market in the component securities comprising the indexes. At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market makers from adequately meeting their obligations to maintain a fair and orderly market.[17]

The Commission has carefully considered the PCX's proposal to increase position and exercise limits for QQQ options. At the outset, the Commission notes that it still believes the fundamental purpose of position and exercise limits are being served by their existence. However, given the surveillance capabilities of the Exchange and the depth and liquidity in both the QQQ options and the underlying cash market in QQQs, the Commission believes it is permissible to significantly raise position limits for QQQ options without risk of disruption to the options or underlying cash markets. Specifically, the Commission believes that it is appropriate to increase position and exercise limits from 75,000 contracts to 300,000 contracts for QQQ options for several reasons.

First, the Commission believes that the structure of the QQQ options and the considerable liquidity of both the underlying cash and options market for QQQ options lessens the opportunity for manipulation of this product and disruption in the underlying market that a lower position limit may protect against. In this regard, the PCX notes that the average daily trading volumes for the QQQs and QQQ options from January 1, 2001 to November 30, 2001 were 71.21 million shares and 148,181 contracts, respectively. The PCX also notes that the QQQ option is the most actively-traded option in the U.S. markets, and the underlying QQQ is the most actively-traded equity security in the U.S. markets.[18] These factors provide support for higher limits for the QQQ options and differentiate them from other equity options.

Second, the Commission notes that current margin and risk-based haircut methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. Further, the PCX, under Rules 2.16 and 6.8, may impose additional margin on options positions if it determines that this is warranted. The Commission believes that these financial requirements should help to address concerns that a member or its customer may try to maintain an inordinately large unhedged position in QQQ options and will help to reduce risks if such a position is established.

Finally, the Commission believes that the reporting requirements imposed by the Exchange will help protect against potential manipulation. Under PCX Rule 6.6, each member or member organization that maintains a position on the same side of the market in excess of 10,000 contracts in the QQQ option, for its own account or for the account of a customer is required to report certain information. The Exchange also requires members to report subsequent incremental increases in position limits, thus assuring that positions are regularly monitored by the Exchange. In particular, information that must be reported includes, among other things,

[16] 15 U.S.C. 78f(b)(5). In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with Section 3 of the Act. *Id.* at 78c(f).

[17] *Id.*

[18] The PCX has noted that the QQQ is designed to closely track the performance of the Nasdaq-100 Index. According to the PCX, as of November 30, 2001, the market capitalization of the securities underlying the Nasdaq-100 Index was $1.875 trillion.

whether or not the options position is hedged, and if so, a description of the hedge. This information should help the PCX to monitor accounts and determine whether it is necessary to impose additional margin for under-hedged positions, as provided under its rules.

In summary, the financial and reporting requirements noted above should allow the Exchange to detect and deter trading abuses arising from the increasing position and exercise limits, and will also allow the Exchange to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if deemed necessary. These requirements, coupled with the special trading characteristics of the QQQ options noted above, warrant approval of the Exchanges proposal.[19]

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice of filing thereof in the **Federal Register**. The Commission notes that under the current PCX rules, the position and exercise limits applicable to QQQ options is 75,000 contracts. However, due to a 50% reduction in the value of the underlying QQQ on March 20, 2000, the limit was adjusted to 150,000 contracts. The position and exercise limits are scheduled to revert back to 75,000 contracts after the January options expiration occurring on January 18, 2002. The Exchange has represented to the Commission that limits of 75,000 contracts for the QQQ options could substantially reduce depth and liquidity in the QQQ market. The Exchange has further represented that increasing position and exercise limits from 75,000 contracts to 300,000 contracts for QQQ options will provide greater flexibility for market participants attempting to hedge their market risks. The Commission, therefore, believes for the reasons noted above that it is appropriate to approve this proposed rule change increasing the position and exercise limit to 300,000 contracts on January 18, 2002. The Commission also believes it is appropriate to approve the clarifying language proposed for Exchange Rule 6.9(a) noted above. Accordingly, the Commission finds that there is good cause, consistent with Section 6(b)(5) of the Act,[20] to approve the proposal on an accelerated basis.

[19] Of course, the Commission expects that PCX will take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in the underlying QQQ, should any unanticipated adverse market effects develop due to the increased limits.

[20] 15 U.S.C. 78f(b)(5).

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[21] that the proposed rule change (SR–PCX–2002–03) is hereby approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[22]

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 02–1902 Filed 1–24–02; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45310; File No. SR–Phlx–2002–06]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change by Philadelphia Stock Exchange, Inc. to Increase Position And Exercise Limits for Nadsaq-100 Index Tracking Stock Options

January 18, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934,[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 15, 2002, 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 and II below, which Items have been prepared by the Exchange. On January 16, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change, as amended.

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

The Phlx proposes to increase position and exercise limits for Nasdaq-100 Index Tracking Stock [4] (''QQQ'') options to 300,000 contracts on the same side of the market. The Phlx represents that its reporting requirements for QQQ options will serve to identify options holdings and information concerning the hedging of these positions.

The text of the proposed rule change is available at the Office of the Secretary, Phlx, and at the Commission.

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 Phlx 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 III below. The Phlx 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

1. Purpose

The Exchange is proposing to increase position and exercise limits for QQQ options up to 300,000 contracts on the same side of the market. The Exchange will continue to require that member organizations report all QQQ options positions exceeding 200 contracts pursuant to Exchange Rule 1003(a). Moreover, for accounts holding positions in excess of 10,000 contracts on the same side of the market, the Exchange will also continue to require information concerning the extent to which such positions are hedged. The Phlx believes that increasing position and exercise limits from 75,000 to 300,000 contracts for QQQ options will provide greater flexibility for market participants attempting to hedge their market risks.[5] In addition, Exchange staff will be able to re-focus efforts and resources to other notable areas.

Potential Manipulation

Position limits restrict the number of options contracts that an investor, or a

[21] 15 U.S.C. 78s(b)(2).

[22] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] Amendment No. 1 supercedes and replaces the original 19b–4 filing in its entirety.

[4] The Phlx represents that Nasdaq-100, Nasdaq-100 Index (''Index''), Nasdaq, The Nasdaq Stock Market, Nasdaq-100 Shares, Nasdaq-100 Trust, Nasdaq-100 Index Tracking Stock, and QQQ are trademarks or service marks of The Nasdaq Stock Market, Inc. (''Nasdaq'') and have been licensed for use for certain purposes of the Phlx (''Licensee'') pursuant to a License Agreement with Nasdaq. The Index determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust, or the beneficial owners of Nasdaq-100 Shares. The Phlx represents that Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising or calculating the Index in the future.

[5] Although the current position limit is 75,000 contracts, due to a 50% reduction in the value of the underlying QQQ on March 20, 2002, the limit was adjusted to 150,000.