

Section 6(b)(5) in particular,⁹ in that it is designed to prevent fraudulent and manipulative acts and practices, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in, securities as well as to protect investors and the public interest, by bolstering the exercise advice requirement to include all non-expiration exercises, not just exercises of 25 or more contracts. Specifically, the Phlx believes that requiring exercise advices for all American-style index options exercised prior to expiration should enhance surveillance efforts regarding compliance with the exercise cut-off time by providing a more complete audit trail.

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

The self-regulatory organization does not believe that the proposed rule change will impose any inappropriate 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve the proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing also will be available for inspection and copying at the principal office of the self-regulatory organization. All submissions should refer to File No. SR-Phlx-96-21 and should be submitted by July 16, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-37320; File No. SR-Phlx-96-07]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the Philadelphia Stock Exchange, Inc., to Adopt a Market Index Option Hedge Exemption

June 18, 1996.

I. Introduction

On February 13, 1996, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), 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 to amend Commentary .01 to Phlx Rule 1001A to establish a hedge exemption from broad-based (Market) index option position and exercise limits.³

The proposed rule change appeared in the Federal Register on March 21, 1996.⁴ No comments were received on

the proposed rule change. This order approves the Phlx's proposal.

II. Background and Description

The Phlx proposes to adopt a market index option hedge exemption under which broad-based index option positions hedged in accordance with the proposal would be entitled to exceed existing position and exercise limits by up to two-times about the limit.⁵ According to the Phlx, the purpose of the proposal is to establish a provision parallel to the hedge exemption of equity options⁶ as well as the broad-based index option hedge exemptions that are in place at other option exchanges.⁷

In order to qualify for the exemption, the market index option position must be hedged by share positions in at least 20 stocks, or securities immediately or readily convertible into such stock,⁸ in four industry groups comprising the index, of which no one component security accounts for more than 15% for the value of the portfolio hedging the index option position. Under the proposal, no position in a market index option may exceed two-times the broad-based index option position specified in Phlx Rule 1001A(a).⁹ In addition, the underlying value of the option position may not exceed the value of the

⁵ The Exchange notes that is adopting the language "two times above the limit" to signify "in addition to" the current position limit. For instance, if the position limit for a market index option is 25,000 contracts, an additional 50,000 contracts under this proposal would be permitted, for a total of 75,000 contracts. This language parallels a recent change by another exchange. See Securities Exchange Act Release No. 36609 (December 20, 1995), 60 FR 67002 (December 27, 1995) (notice of File No. SR-CBOE-95-68).

⁶ See Phlx Rule 1001, Commentary .07. See also Securities Exchange Act Release No. 35738 (May 18, 1995), 60 FR 27573 (May 24, 1995) (order approving permanent hedge exemption pilot programs) (File Nos. SR-Phlx-95-10, SR-Amex-95-13, SR-CBOE-95-13, SR-NYSE-95-04, and SR-PSE-95-05).

⁷ See, e.g., CBOE Rule 24.4 and the Interpretations and Policies thereunder, and Commentary .01 to Amex Rule 904C.

⁸ The Exchange permits the use of convertible securities in its equity option hedge exemption as long as such securities are immediately or readily convertible into the underlying stock. See Securities Exchange Act Release No. 32174 (April 20, 1993), 58 FR 25687 (April 27, 1993) (order approving file No. SR-Phlx-92-22). Similarly, other options exchange permit the use of convertible securities with respect to broad-based index option hedge exemptions.

⁹ Under Phlx Rule 1001A(a), the Value Line Composite Index ("VLE"), the U.S. Top 100 Index ("TPX"), and the National Over-the-Counter Index ("XOC") each have a position limit of 25,000 contracts, of which no more than 15,000 contracts can be in the nearest expiration month. The Phlx notes that the Big Cap Index ("MKT") is no longer listed on the Exchange.

⁹ 15 U.S.C. § 78f(b)(5)(1988).

¹⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1) (1988).

² 17 CFR 240.19b-4 (1994).

³ Position limits impose a ceiling on the number of option contracts which an investor or group of investors acting in concert may hold or write in each class of options on the same side of the market (i.e., aggregating long calls and short puts or long puts and short calls). Exercise limits prohibit an investor or group of investors acting in concert from exercising more than a specified number of puts or calls in a particular class of options within five consecutive business days.

⁴ See Securities Exchange Act Release No. 36976 (March 14, 1996), 61 FR 11668 (March 21, 1996).

underlying portfolio employed as the hedge.¹⁰

In addition, under the proposal, exercise limits will continue to correspond to position limits, so that investors may exercise the number of contracts set forth as the position limit, as well as those contracts exempted by this proposal, during five consecutive business days.¹¹

The Phlx notes that broad-based index option hedge exemptions are in place at other options exchanges. Generally, these index option hedge exemptions allow public customers to apply for position limit exemptions in broad-based index options that are hedged with exchange-approved qualified stock portfolios.

In light of the Exchange's experience with the equity option hedge exemption, as well as its review of the rules of the other options exchanges, the Phlx believes that a similar hedge exemption for its market index options is appropriate. The Phlx also believes that the proposed conditions for granting such an exemption are reasonable and in line with prior Commission-approved provisions.

According to the Phlx, trading volume for index options has markedly increased. In 1994, volume increased two-fold over 1993, from 1,119,147 contracts to 2,456,685. In 1995, volume remained steady with over 2,783,043 contracts traded. The Phlx attributes the recent growth in trading and open interest to institutional trading, which, according to the Phlx, is typically hedged by baskets of the underlying stocks.

The Phlx proposes to exempt positions in broad-based index options in a manner which balances the hedging needs of index options traders with the Exchange's obligation to maintain a fair and orderly market. The Phlx believes that a hedge exemption up to two-times above the limit for broad-based index options would considerably enhance the

attractiveness of these products for institutional traders, who would, in turn, trade more of the product in a hedged manner and thereby provide stabilizing liquidity in both the index options and the underlying securities.

The Phlx also believes that it is appropriate and necessary to expand the availability of the exemption beyond public customers. The Phlx states that significant increases in the depth and liquidity of the market for these index options could result from permitting firm and proprietary traders to be eligible for the exemption. According to the Phlx, because customers rely, for the most part, on a limited number of proprietary traders to facilitate large-sized orders, not including such traders in the exemption effectively reduces the benefit of the exemption to customers. While large-sized positions in market index options are most commonly initiated by institutional trades hedging stock portfolios on behalf of public customers, the Phlx believes that proprietary traders should be afforded the same exemption so that they may fulfill their role as facilitators.

The Phlx also believes that the hedge exemption is necessary to better meet the needs of investors who use Phlx market index options for investment and hedging purposes. According to the Phlx, many institutional traders and portfolio managers deal in dollar amounts much greater than that permissible under current position limit levels and have expressed that Exchange position limits hamper their ability to fully utilize such index options.

The Phlx believes that the proposed broad-based index option hedge exemption should not increase the potential for disruption or manipulation in the markets for the stocks underlying each index. The Phlx notes that this is because the proposal incorporates several surveillance safeguards, which the Phlx will employ to monitor the use of this exemption. Specifically, the Exchange will require that a form be filed by members firms and their customers who seek exemptions, in lieu of granting an automatic exemption. The Exchange will review the request and approve only those applications that satisfy the hedge exemption requirements. Moreover, the hedge exemption form must be kept current, with information updated as warranted. Any information concerning the dollar value and composition of the stock portfolio,¹² or its equivalent, the current hedged and aggregate options positions,

and any stock index futures positions must be promptly provided to the Exchange. In addition, the Exchange's Market Surveillance Department will monitor trading activity in Phlx traded index options and the stocks underlying those indexes to detect potential frontrunning and manipulation, as well as review such trading to ensure that the closing of positions subject to the exemption are conducted in a fair and orderly manner. On a daily basis, the Exchange's Market Surveillance Department will also monitor each option contract to ensure that it is hedged by the equivalent dollar amount of component securities.

III. Discussion

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, and, in particular, the requirements of Section 6(b)(5) thereunder.¹³ The Commission believes that providing for increased position and exercise limits for broad-based index options in circumstances where those excess positions are fully hedged with offsetting positions will provide greater depth and liquidity to the market and will allow investors to hedge their stock portfolios more effectively, without significantly increasing concerns regarding intermarket manipulations or disruptions of either the options market or the underlying stock market.

Specifically, the Phlx proposal contains safeguard that should make it difficult to use the exempted positions to disrupt or manipulate the market. First, request for the exemption must be approved by the Phlx, which should ensure that the hedges are appropriate for the position being taken and are in compliance with Phlx rules. Second, the stock portfolio must consist of at least 20 stocks, or securities convertible into such stock, in four industry groups comprising the index, of which no one component security accounts for more than 15% of the value of the portfolio hedging the index option position, so that the increased positions are less likely to be used in a leveraged manner in any manipulative scheme. As noted above, the value of the underlying hedging portfolio is equal to (1) the total market value of the net stock position; less (2) the value of: (a) Any offsetting calls and puts in the respective index options; (b) any offsetting positions in related stock index futures or options; and (c) any economically equivalent

¹⁰ The value of the underlying portfolio is determined as follows: (1) the total market value of the net stock position; less (2) the value of: (a) any offsetting calls and puts in the respective index option; (b) any offsetting positions in related stock index futures or options; and (c) any economically equivalent positions.

The values of offsetting positions are determined by the multiplying the number of opposite-side-of-the-market (offsetting) calls, puts, or futures contracts by the index value and by the index multiplier. Then, the value is subtracted from the market value of the portfolio. This number must be compared with the underlying value of the option position, in excess of the standard or base position limit being hedge/exempted, which is calculated by multiplying the number of option contracts for which the exemption is sought by the index value and the multiplier; this value cannot exceed the value of the underlying portfolio.

¹¹ See Phlx Rule 1002A.

¹² The Phlx notes that as the dollar value of the hedging portfolio fluctuates, the number of exempt contracts may need to be adjusted.

¹³ 15 U.S.C. § 78f(b)(5) (1988).

positions. Third, both the options and stock positions must be initiated and liquidated in an orderly manner. This means that a reduction of the options position must occur at or before the corresponding reduction in the stock portfolio position, thereby helping to ensure that the stock transactions are not used to impact the market so as to benefit the options positions. Fourth, the Phlx's Market Surveillance Department must be notified in writing for approval prior to liquidating or initiating any such position as well as of any change in the portfolio or futures positions which materially affects the value of the qualified portfolio. Fifth, the proposal provides a ceiling on the maximum size of the options position by providing that positions established under the proposal may not exceed two-times the limits set forth in Exchange Rule 1001A(a). In addition, the Exchange may determine to grant a position limit exemption for less than the maximum of two-times above the limit.

The Commission notes that the Phlx's surveillance procedures are designed to detect as well as deter manipulation and market disruptions. In particular, the Phlx will monitor the options position of persons utilizing the hedge exemption on a daily basis to ensure that each option contract is hedged by the equivalent dollar amount of component securities.¹⁴ In addition, the Phlx's Market Surveillance Department will monitor trading activity in Phlx traded index options and the stocks underlying those indexes to detect potential frontrunning and manipulation, as well as to review such trading to ensure that the closing of positions subject to the exemption are conducted in a fair and orderly manner. Violation of any of the provisions of the market index hedge exemption, absent reasonable justification or excuse, will result in the withdrawal of the hedge exemption and subsequent denial of an application for hedge exemption thereunder.

Finally, the Commission believes that it is reasonable for the Phlx to allow firm and proprietary traders as well as public customers to utilize the proposed hedge exemption. The Commission believes that extending the broad-based index option hedge exemption to firm and proprietary traders may help to

increase the depth and liquidity of the market for market index options and may help to ensure that public customers receive the full benefit of the exemption. Moreover, the Phlx's monitoring procedures, as described above, should be able to detect abuses and ensure that the options position, whether firm, proprietary trader, or customer, are properly hedged.

IV. Conclusion

For the foregoing reasons, the Commission finds that the Phlx's proposal to establish a hedge exemption from broad-based index option position and exercise limits is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁵ that the proposed rule change (SR-Phlx-96-07) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-37323; File No. SR-Phlx-96-11]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Exchange's Calculation of Settlement Values for Cash/Spot Foreign Currency Option Contracts ("3-D Options")

June 18, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on April 30, 1996, 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 self-regulatory organization. On May 20, 1996, the Exchange submitted to the Commission Amendment No. 1 to the proposed rule change.² The Commission is publishing this notice to solicit

¹⁵ 15 U.S.C. § 78s(b)(2) (1988).

¹⁶ 17 CFR 200.30-3(a)(12) (1994).

¹ 15 U.S.C. 78s(b)(1).

² See letter from Murray L. Ross, Vice President and Secretary, Phlx, to Anthony P. Pecora, Attorney, SEC, dated May 17, 1996. In this letter, the Phlx represented that the limitation of liability clause may not be relied upon to limit the Exchange's liability to nonmembers for any intentional or negligent violations of the federal securities laws. In addition, the Exchange made some minor clarifying edits.

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 Phlx proposes to amend Phlx Rule 1057 in order to provide the Exchange with the election to calculate settlement values for the cash/spot Dollar Denominated Delivery foreign currency option contracts ("3-D options"). In addition, the Exchange proposes to amend Phlx Rule 1057 by including a "limitation of liability" clause for the settlement of 3-D options similar to Phlx Rule 1102A, which limits the Exchange's liability in the calculation and dissemination of settlement values.

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

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

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

1. Purpose

On March 8, 1994, the Commission approved 3-D options for listing on the Phlx.³ Currently, the closing settlement value for 3-D options is calculated by a market information vendor acting as the Exchange's designated agent. The market information vendor will collect the bid and offer quotations for the current foreign exchange spot price from quotations submitted by at least fifteen interbank foreign exchange market participants, which the designated agent will select randomly from a list of twenty-five active interbank foreign exchange market participants. After discarding the five highest and the five lowest bids and offers, the market information vendor averages the remaining ten bids and offers to arrive at a closing settlement price.

The Phlx proposes to amend Phlx Rule 1057 to provide the Exchange with

³ See Securities Exchange Act Release No. 33732 (Mar. 8, 1994), 59 FR 12023 (approving File No. SR-Phlx-93-10).

¹⁴ Market participants granted a hedge exemption are also required to keep their application forms for the hedge exemption current and promptly provide the Phlx with any information concerning the dollar value and composition of the stock portfolio, the current hedged and aggregate options positions, and any stock index futures positions, or economically equivalent positions.