

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, located at the above address. Copies of such filing will also be available for inspection and copying at the principal office of the self-regulatory organization. All submissions should refer to File No. SR-Amex-98-22 and should be submitted by July 30, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40158; File No. SR-CBOE-98-23]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to the Elimination of Position and Exercise Limits for Options on Broad-Based Indexes

July 1, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 11, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. 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 CBOE proposes to eliminate position and exercise limits for broad-based index options. The current

reporting procedures, with slight modifications, which serve to identify large option holdings and hedging information, will remain in place.

The text of the proposed rule change is available at the Office of the Secretary, CBOE 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 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

The CBOE is proposing the elimination of position and exercise limits for broad-based index options for the reasons detailed below. The Exchange will, however, still require that member organizations file reports with the Exchange in the event that they maintain proprietary or customer positions in excess of Exchange established reporting thresholds in the different broad-based index option products.

**Manipulation.** The CBOE believes that position and exercise limits in broad-based index options 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.<sup>3</sup> On the fifteenth anniversary of listed index options trading, the Exchange

believes that the size of the market underlying broad-based index options is so large as to dispel any concerns regarding market manipulation. To date, there has not been a single disciplinary action involving manipulation in any broad-based index product listed on the Exchange. The Exchange believes that its fifteen years of experience conducting surveillance of index options and program trading activity is sufficient to identify improper activity. The CBOE believes that routine oversight inspections of CBOE's regulatory programs by the Commission have not uncovered any inconsistencies or shortcomings in the manner in which index option 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 stock basket components. Moreover, the CBOE believes that current NYSE Market on Open and Market on Close procedures facilitate the orderly unwinding of large index program trades.<sup>4</sup> Further, the significant increases in unhedged options capital charges resulting from the September 1997 adoption of risk-based haircuts and the high margin requirements applicable to these products under Exchange rules serves as a more effective protection than position limits ever have or ever could.<sup>5</sup>

**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."<sup>6</sup> However, in today's market, the Exchange believes that position and exercise limits severely hamper CBOE's ability to compete with the OTC and futures markets. Investors who trade listed options on the CBOE are placed at a serious disadvantage in comparison to the OTC market where index options and other types of index based derivatives (e.g., forwards and swaps) are not subject to position and exercise limits. Member firms continue to express concern to the Exchange that position limits on CBOE products are an impediment to their business and that they have no choice but to move their

<sup>4</sup> See NYSE Informational Memo Number 96-34 (November 8, 1996).

<sup>5</sup> See Exchange Act Release No. 34-38248 (February 6, 1997), 62 FR 6474 (February 12, 1997) (adopting Risk-Based Haircuts); and CBOE Rule 24.11 Margins.

<sup>6</sup> See H.R. Rep. No. IFC-3, 96th Cong., 1st Sess. At 189-91 (Comm. Print 1978).

<sup>15</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> Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11) (order approving an increase in OEX position and exercise limits).

business to the OTC market where position limits are not an issue.

*Position and exercise limits restrict legitimate options use.* The Exchange believes that the current base limit for broad-based index options<sup>7</sup> is not adequate for the hedging needs of institutions which engage in trading strategies differing from those covered under the index hedge exemption policy (e.g., delta hedges, OTC vs. listed hedges). Moreover, the current index hedge exemption, which requires a daily monitoring of positions and reports to the exchange is too cumbersome. CBOE and member firm compliance staff devote an inordinate amount of time monitoring a firm's position, when in fact, the firm is more than adequately capitalized to carry such sizeable option positions. The CBOE believes that, with the elimination of position limits for these products, staff resources could be better utilized elsewhere.

*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 a broad-based index option. 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.<sup>8</sup> It should also be noted that the Exchange has the authority under paragraph (h) of Rules 12.3 and 12.10 to impose a higher margin requirement upon the member of member organization when the Exchange determines a higher requirement is warranted. In addition, the Commission's net capital rule, Rule 15c3-1 under the Exchange Act, imposes a capital charge on members to the extent of any margin deficiency

resulting from the higher margin requirement.

*FLEX Equity options.* In 1997, the SEC approved the elimination of position and exercise limits in FLEX Equity options under a two-year pilot program.<sup>9</sup> To date, there have been no adverse effects on the market as a result of the elimination of position and exercise limits. Member firms have commented favorably on this change and believe that it is the first step towards eliminating position and exercise limits in all option products. In its release approving the elimination of FLEX equity option limits for a two-year pilot, period, the Commission stated that the elimination of position limits will allow the listed options markets to better compete with the OTC market.<sup>10</sup>

[T]he elimination of position and exercise limits for FLEX equity options allows the Exchanges to better compete with the growing OTC market in customized equity options, thereby encouraging fair competition among brokers and exchange markets. The attributes of the Exchanges' options markets versus an OTC market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, parameters and procedures for clearance and settlement, and the guarantee of the OCC for all contracts traded on the Exchanges.<sup>11</sup>

*Reporting requirements.* The Exchange will require that each member or member organization that maintains a position on the same side of the market in excess of 100,000 contracts in any broad based index option class, for its own account or for the account of a customer report certain information. This data would include, but would not be 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 would continue to be exempt from this reporting requirement as market-maker information can be accessed through the Exchange's market surveillance systems. The Exchange proposes to increase the reporting level to 100,000 contracts<sup>12</sup> from the current levels (i.e., 45,000 for

SPX and 65,000 for OEX) for the following reasons. To date, information collected shows that member firms and customer accounts are hedged with either futures, options on futures or index options. This information can be obtained either through in-house surveillance systems, from the Chicago Mercantile Exchange or by contacting the member firm. Considering that the CBOE currently lists sixteen (16) different broad-based index option products, imposing a uniform reporting number will eliminate confusion. The CBOE believes that an increase in the reporting level to 100,000 contracts for all broad based index products will result in the collection of more meaningful information, and will lessen the administrative burden for member firms and for the Exchange staff. In addition, the general reporting requirement for customer accounts that maintain a position in excess of 200 contracts will remain at this level for broad based index options.<sup>13</sup> Last, it is important to note that the proposed 100,000 contract reporting requirement is above and beyond what is currently required in the OTC market. NASD member firms are only required to report index option positions in excess of 200 contracts and are not required to report any related hedging information.

## 2. Basis

The Exchange believes that the proposal is consistent with Section 6(b)<sup>14</sup> of the Act, in general, and Section 6(b)(5)<sup>15</sup> of the Act, 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, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

The Exchange believes that the proposed rule changes are consistent with Section 6(b) of the Act in general, and further the objectives of Section 6(b)(5), in particular, in that they are designed to promote just and equitable principles of trade and to protect investors and the public interest.

<sup>7</sup> The base limits for broad-based index options are set forth in paragraph (a) of Rule 24.4. The limits range from 25,000 contracts in OEX to 1,000,000 contracts on options based on the Dow Jones Industrial Average ("DJIA"), which is a contract that is based on one-one hundredth of the value of the DJIA.

<sup>8</sup> Exchange Act Rule 15c3-1 requires a capital charge equal to the maximum potential loss on a broker-dealer's aggregate index position over a +(-) 10% market move. Exchange margin rules require margin on naked index options which are in or at-the-money equal to a 15% move in the underlying index; and a minimum 10% charge for naked out-of-the-money contracts. At an index value of 9,000 this approximates to a \$135,000 to \$90,000 requirement per each unhedged contract. This compares to an approximate \$36,000 requirement for an equivalent index futures contract position.

<sup>9</sup> Exchange Act Release No. 39032 (September 9, 1997), 62 FR 48683 (September 16, 1997) (order approving SR-CBOE-96-79).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 48685. The Commission notes that approval of the elimination of position and exercise limits for FLEX equity options for a two-year pilot period and was based on several other factors including, in large part, additional safeguards adopted by the exchanges to allow them to monitor large options positions.

<sup>12</sup> Currently only OEX and SPX are subject to reporting requirements beyond those required by Exchange Rule 4.13. The Exchange would expand this revised reporting requirement to all broad-based index options.

<sup>13</sup> See Exchange Rule 4.13 *Reports Related to Position Limits*.

<sup>14</sup> 15 U.S.C. 78f(b).

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

*C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments on the proposed rule change were neither solicited nor received.

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

Within 35 days of the date of 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 such 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, 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, 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 in the Commission's Public Reference Room, located at the above address. Copies of such filing will also be available for inspection and copying at the principal office of the self-regulatory organization. All submissions should refer to File No. SR-CBOE-98-23 and should be submitted by July 30, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

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

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-40160; File No. SR-CBOE-98-25]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to a Change in Position and Exercise Limits for Equity Options**

July 1, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 8, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. 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 CBOE proposes to increase the position and exercise limits on equity options traded on the Exchange to three times their current levels.

The text of the proposed rule change is available at the Office of the Secretary, CBOE 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 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**

The CBOE is proposing to increase the position and exercise limits for equity options traded on the Exchange to three times their current levels. Currently,

Rule 4.11 subjects equity options to one of five different position limits depending on the trading volume and outstanding shares for the underlying security. Rule 4.12 establishes exercise limits for the corresponding options at the same levels.<sup>3</sup> The limits are: 4,500; 7,500; 10,500; 20,000; and 25,000 contracts on the same side of the market. Under the proposed changes the new limits will be: 13,500; 22,500; 31,500; 60,000; and 75,000. The Exchange believes sophisticated surveillance techniques at options exchanges adequately protect the integrity of the markets for the options that will be subject to these increased position and exercise limits.

**Manipulation.**

The CBOE believes that position and exercise limits, at their current levels, 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 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.<sup>4</sup>

On the twenty-fifth anniversary of listed options trading, the Exchange believes that the existing surveillance procedures and reporting requirements at options exchanges and clearing firms that have been developed over the years are able to properly identify unusual and illegal trading activity. In addition, the CBOE believes that routine oversight inspections of CBOE's regulatory programs by the Commission have not uncovered any material inconsistencies or shortcomings in the manner in which the Exchange's market surveillance is conducted. These procedures entail a daily monitoring of market movements

<sup>3</sup> CBOE Rule 4.12 states: "no member shall exercise, for any account in which it has an interest or for the account of any customer, a long position in any options contract where such member or customer, acting alone or in concert with others, directly or indirectly has or will have exercised within any five consecutive business days aggregate long positions in any class of options dealt in on the Exchange in excess of" the established limits set by the Exchange.

<sup>4</sup> Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (CBOE-97-11) (order approving an increase in OEX position and exercise limits).

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

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

<sup>16</sup> 17 CFR 200.30-3(a)(12).