

*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).

via automated surveillance techniques to identify unusual activity in both the options and underlying stock. Further, the Exchange believes the significant increases in unhedged options capital charges resulting from the September 1997 adoption of risk-based haircuts and the Exchange margin requirements applicable to these products under Exchange rules serves as a more effective protection than position limits.<sup>5</sup>

Furthermore, large stock holdings must be disclosed to the Commission by way of Schedule 13D or 13G.<sup>6</sup> Options positions are part of any reportable positions and cannot be legally hidden. In addition, Exchange Rule 4.13—which requires members to file reports with the Exchange for any customer who held aggregate long or short positions of 200 or more option contracts of any single class for the previous day—will remain unchanged and an important part of the Exchange's surveillance efforts.

*Position and exercise limits restrict legitimate options use.* In the Exchange's view, equity position limits prevent large customers like mutual funds and pensions funds from using options to gain meaningful exposure to individual stocks, resulting in lost liquidity in both the options market and the stock market. The Exchange further believes that equity position limits also act as a barrier to the use of options by corporations wishing to implement options strategies with their own stock. For example, existing equity position limits could restrict the number of put options that could be sold under a corporate buyback program.<sup>7</sup>

*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 an equity 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. 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

or 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.

*Past increases have had no adverse consequences.* Equity position limits have been gradually expanded from 1,000 contracts in 1973 to the current level of 25,000 contracts for the largest and most active stocks. In 1997, the SEC approved the elimination of position and exercise limits in FLEX Equity options under a two-year pilot program.<sup>8</sup> To date, there have been no adverse affects on the market as a result of the past increases in the limits for equity options or the elimination of position and exercise limits for FLEX Equity options.

*Changes will allow options exchanges to compete more fairly with OTC markets.* 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>9</sup> However, in today's market, equity position limits put listed options at a competitive disadvantage to over-the-counter derivatives. OTC dealers can execute options trades through overseas subsidiaries not subject to NASD regulation, and therefore not subject to position limits. As a result, the largest trades can go unobserved and unmonitored for regulatory and oversight purposes. 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 business to off-shore markets where position limits are not an issue.

In addition, the NASD has recently filed a proposed rule change with the Commission<sup>10</sup> which proposes to raise

the position limits for conventional equity options (*i.e.*, those options not issued, or subject to issuance by the Options Clearing Corporation) to three times their current levels (which is the same as three times the levels established by current Exchange rules for standardized options). Because conventional options often have nearly the identical terms as standardized, Exchange-traded options, the Exchange believes the position limits for standardized options should be at least as high as those for conventional options.

The proposed changes should help to attract business back to the Exchange where the trades will be subject to reporting requirements and surveillance. In its release approving the elimination of FLEX equity option limits for a two-year pilot period,<sup>11</sup> the Commission stated that the elimination of position limits will allow the listed options markets to better compete with the OTC market.

[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>12</sup>

It should also be noted that individual stocks are not subject to position limits. Investors can theoretically hold 100% of a company's shares outstanding as long as they file the appropriate Schedule 13D or 13G. The Exchange believes the increase in the position and exercise limits will better enable the Exchange to compete against the OTC markets and is an appropriate and responsible increase given the nature of the Exchange's surveillance.

## 2. Basis

The Exchange believes that the proposal is consistent with Section 6(b)<sup>13</sup> of the Act, in general, and Section

Release No. 40087 (June 12, 1998), 63 FR 33746 (June 19, 1998).

<sup>11</sup> See Exchange Act Release No. 39032 (September 9, 1997), 62 FR 48683 (September 16, 1997).

<sup>12</sup> *Id.* at 48685. The Commission notes that approval of the elimination of position and exercise limits for FLEX equity options was granted 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>13</sup> 15 U.S.C. 78f(b).

<sup>5</sup> See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997) (adopting Risk Based Haircuts); and CBOE Rule 12.3 *Margins*.

<sup>6</sup> Exchange Act Rule 13d-1.

<sup>7</sup> The Commission notes that issuers would, of course, need to comply with all applicable provisions of the federal securities laws in conducting their share repurchase programs.

<sup>8</sup> See Exchange Act Release No. 39032 (September 9, 1997), 62 FR 48683 (September 16, 1997) (order approving SR-CBOE-96-79).

<sup>9</sup> See H.R. Rep. No. IFC-3, 96th Cong., 1st Sess. At 189-91 (Comm. Print 1978).

<sup>10</sup> See Exchange Act Release No. 39893 (April 21, 1998), 63 FR 23317 (April 28, 1998) (notice of SR-NASD-98-23). The Commission notes that the NASD's position limit filing was approved on June 12, 1998. The NASD's position limit filing established position and exercise limits for conventional equity options identical to those being proposed by CBOE in this filing. See Exchange Act

6(b)(5)<sup>14</sup> of the Act, in particular, in that it is designed to promote just and equitable principles of trade and to protect investors and the public interest.

#### *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 that is not necessary or appropriate in furtherance of the purposes of the Act.

#### *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-98-25 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. 34-40144; File No. SR-CHX-98-17]

### **Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by the Chicago Stock Exchange, Inc., to Extend the Exchange's Clearing the Post Policy for Cabinet Securities**

June 30, 1998.

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 18, 1998, the Chicago Stock Exchange, Inc. ("CHX" or the "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 CHX. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval to the proposal.

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

The Exchange proposes to extend the current pilot program that amends interpretation and policy .02 of CHX Rule 10 of Article XX and amends CHX Rule 11 of Article XX relating to clearing the post for cabinet securities on an interim basis until December 6, 1998, or until the Commission approves SR-CHX-98-13,<sup>3</sup> whichever occurs first. The initial six-month pilot program was approved by the Commission on January 6, 1998, and

<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> Proposed rule change SR-CHX-98-13, which was filed with the Commission on June 10, 1998, (i) requests permanent approval of the policy that permits market makers to clear the cabinet post by phone, and (ii) proposes to expand this policy to include all securities traded on the trading floor.

expires on July 6, 1998.<sup>4</sup> The text of the proposed rule change is as follows:

Additions are italicized; deletions are bracketed.

## **ARTICLE XX**

Rule 10. Manner of Bidding and Offering.

No change in text.

. . . Interpretations and Policies

.02 Clearing the Post.

Policy. All orders received by floor brokers or originated by market makers on the floor of the Exchange must effectively clear the post before the orders may be routed to another market, either via the ITS System or through the use of alternative means.

Floor brokers who receive an order on the floor have a fiduciary responsibility to seek a best price execution for such order. This responsibility includes clearing of the Exchange's post prior to routing an order to another market so that other buying and selling interest at the post can be checked for a potential execution that may be as good as or better than the execution available in another market.

Market makers are required to provide depth and liquidity to the Exchange market, among other things. Exchange Rules require that all market maker transactions constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market. In so doing, market makers must adhere to traditional agency/auction market principles on the floor. Transactions by Exchange market makers on other exchanges which fail to clear the Exchange post do not constitute such a course of dealings.

Notwithstanding the above, it is understood that on occasion a customer will insist on special handling for a particular order that would preclude it from clearing the post on the Exchange floor. For example, a customer might request that a specific order be given a primary market execution. These situations must be documented and reported to the Exchange. Customer directives for special handling of all orders in a particular stock or all stocks, however, will not be considered as exceptions to the clearing the post policy.

All executions resulting from bids and offers reflected on Instinet terminals resident on the Exchange floor constitute "orders" which are "communicated" to the Exchange floor. Therefore, all orders resulting from interest reflected on Instinet terminals

<sup>4</sup> Securities Exchange Act Release No. 39519 (January 6, 1998), 63 FR 1985 (January 13, 1998).

<sup>14</sup> 15 U.S.C. 78f(b)(5).