

reviews for NNM issues; the reviews will be done on an annual basis along with other dually listed issues and rather than a quarterly basis as required for exclusive issues.<sup>5</sup>

### III. Discussion

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.<sup>6</sup> In particular, the Commission believes the proposal is consistent with the requirements of Section 6(b)(4) of the Act<sup>7</sup> because it is designed to provide for the equitable allocation of reasonable dues, fees and other charges among members, issuers and other persons using its facilities. The proposal fairly allocates fees among issuers, NYSE, AMEX and NNM. The proposal provides issuers that list on both the PCX and NNM with the lower fees and lighter maintenance schedule as are currently provided to NYSE and AMEX issues. The Commission believes such reduced fees are appropriate and reasonable because the costs incident to maintaining exclusive issues are greater than costs incident to maintaining dually listed issues. The Exchange's costs incident to dually listed issues are lower because it requires only one maintenance review annually, rather than the quarterly reviews required for exclusive issues.

In addition, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act.<sup>8</sup> The Commission believes the proposal fosters cooperation and coordination between persons engaged with regulating securities transactions. The PCX reduced its own review process on NNM issues based in part on the review process of Nasdaq. According to the PCX, Nasdaq is a primary listing association and bears the primary obligation to ensure that its issuers meet appropriate listing standards. The Commission also believes that the proposal is not designed to permit unfair discrimination between issuers because the Exchange listing maintenance reviews for dually listed NYSE, AMEX and NNM issues are all on an annual basis.

<sup>5</sup> The PCX Policy and Procedures Manual Section 903.01 provides for annual listing maintenance reviews for dually listed issues.

<sup>6</sup> In reviewing this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>7</sup> 15 U.S.C. 78f(b)(4).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>9</sup> that the proposed rule change (SR-PCX-98-32) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40397; File No. SR-PCX-98-19]

#### Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change Relating to Capital Requirements and Guaranteed Participation of Lead Market Makers

September 3, 1998.

#### I. Introduction

On April 16, 1998, the Pacific Exchange, Inc. ("PCX" or "Exchange"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, filed with the Securities and Exchange Commission ("Commission"), a proposed rule change to amend PCX Rule 6.82 concerning Lead Market Makers. The Exchange filed Amendment No. 1 to the proposed rule change with the Commission on June 4, 1998.<sup>3</sup>

The proposed rule change was published for comment in the **Federal Register** on June 15, 1998.<sup>4</sup> No comments were received on the proposal. This order approves the proposal.

#### II. Description of the Proposal

PCX Rule 6.82 sets forth the basic rules and procedures applicable to Lead Market Makers ("LMMs") and the PCX's LMM Program.<sup>5</sup> PCX seeks to amend

<sup>9</sup> 15 U.S.C. 78s(b)(2).

<sup>10</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> Amendment No. 1 clarified the text of the proposed rule change. See letter from Michael D. Pierson, Senior Attorney, to Heidi Pilpel, Special Counsel, Division of Market Regulation, SEC (June 4, 1998).

<sup>4</sup> See Securities Exchange Act Release No. 40070 (June 4, 1998), 63 FR 32691.

<sup>5</sup> The LMM Program is governed by PCX Rules 6.82 and 6.83, which rules apply strictly to options trading. The PCX's LMM Program was granted permanent approval on September 22, 1997. See Securities Exchange Act Release No. 39111, 62 FR 51710 (October 2, 1997).

PCX Rule 6.82 by modifying the capital requirements for LMMs on the exchange and clarifying the procedures applicable to LMM's guaranteed participation. The text of the proposed rule change is available at the offices of the Commission and the Exchange.

#### A. LLM Capital

PCX Rule 6.82(c)(11) currently provides that each LMM on the Exchange must maintain a cash or liquid asset position in the amount of \$100,000 or in an amount sufficient to assume a position of twenty trading units of the security underlying the option the LMM has been allocated, whichever amount is greater. The term "trading unit" means, in the case of stocks, 100 shares.<sup>6</sup> Therefore, LMMs are currently required to maintain a cash or liquid asset position in the amount of \$100,000 or in an amount sufficient to assume a position of 2000 shares of stock in each option issue allocated to the LMM.

The proposed rule change would eliminate the current LMM capital requirement and replace it with another one providing that each LMM must maintain a cash or liquid asset position of at least \$350,000, plus \$25,000 for each issue over eight issues that have been allocated to the LMM.<sup>7</sup> Under the proposal, PCX Rule 6.82(c)(11) will continue to provide that in the event that two or more LMMs are associated with each other and deal for the same LMM account, the LMM capital requirement will apply to such LMMs collectively, rather than to each LMM individually.<sup>8</sup>

The Exchange believes that the current LMM capital requirement, which generally fluctuates as the price of the underlying stock fluctuates, is unduly complicated and difficult to calculate, both for the exchange and for individual LMMs.<sup>9</sup> Additionally, the Exchange believes that all of its LMMs should have cash or liquid asset positions of at least \$350,000 and that the current minimum amount of \$100,000 is insufficient.

#### B. Guaranteed Participation

PCX Rule 6.82(d)(2) currently provides that LMMS are guaranteed 50% participation in transactions

<sup>6</sup> See PCX Rule 5.3(a).

<sup>7</sup> Like the current rule, the proposed rule would not apply to issues traded by an LMM in connection with the Exchange's LMM Book Pilot Program, as provided in PCX Rule 6.82(h).

<sup>8</sup> Cf. CBOE Rule 8.80, Interp. and Policy .02.

<sup>9</sup> In that regard, the Exchange noted in its filing that the Commission's net capital rule also establishes fixed dollar amounts applicable to broker-dealers.

occurring on their disseminated bids or offers in their allocated issues. The rule also provides, however, that an LMM's guaranteed participation may be reduced from 50% to 40% in a multiply-traded issue, and maybe reduced from 50% to 25% in a non-multiply traded issue, if trading in the issue rises to certain levels (and other events occur).

The applicable trading volume requirement, for both multiply-traded and non-multiply traded issues, is an average daily trading volume of 3,000 contracts at the Exchange for three consecutive months. The Exchange believes that the current formulation of this provision is ambiguous and proposes to clarify it by replacing the words "for three consecutive months" with the words "during any three-calendar-month period (measured on a 'rolling' three-calendar-month basis)." <sup>10</sup>

For multiply-traded issues, PCX Rule 6.82(d)(2)(A) also requires that the Exchange's share of multi-exchange customer trading volume drop below a certain level before an LMM's guaranteed participation will be reduced. The proposal clarifies that the applicable customer trading volume levels are to be determined on a monthly basis. <sup>11</sup>

The Exchange is also proposing to adopt Rule 6.82(d)(2)(C) to specify the circumstances under which an LMM may return to receiving a guaranteed 50% participation after having had it reduced to 40% or to 25%. Specifically, the proposal states that "[i]f the Options Allocation Committee has reduced an LMM's guaranteed participation in an issue pursuant to subsections (A) or (B) \* \* \* and average daily trading volume in an issue falls below 3,000 contracts at the Exchange during any three-calendar-month period (measured on a 'rolling' three-calendar-month basis), the Options Allocation Committee will evaluate the LMM's performance in that issue and, based on that evaluation, may raise the LMM's guaranteed participation in that issue from 40% to 50% (in a multiply-traded issue) or from 25% to 50% (in a non-multiply traded issue)." The proposal codifies the

Exchange's existing policy on when an LMM's guaranteed participation may return to 50%.

### III. Discussion

For the reasons discussed below, 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 with the provisions of Section 6(b) <sup>12</sup> of the Act, in general, and furthers the objectives of Section 6(b)(5), <sup>13</sup> in particular, in that it is designed to promote just and equitable principles of trade and to protect investors and the public interest.

#### A. LMM Capital

The proposed new capital requirement provides that each LMM must maintain a cash or liquid asset position of at least \$350,000, plus \$25,000 for each issue over eight issues that have been allocated to the LMM. The proposal increases the minimum capital requirement for a substantial majority of the LMMs currently subject to PCX Rule 6.82.

The Commission finds that the proposed new capital requirement is reasonably designed to assure that LMMs are capable of making deep, liquid, and competitive markets. For LMMs whose minimum capital requirement is increased, the rule change will ensure not only their greater financial stability, but also will enhance their ability to fill large customer orders and compete vigorously with other exchanges in multiply-traded issues. With respect to LMMs whose minimum capital requirement is either decreased or unchanged, the Commission finds, based on the representations of the Exchange, that there are sufficient safeguards (in addition to the proposed minimum capital requirement) to assure that such LMMs are adequately capitalized. <sup>14</sup>

Moreover, the Commission believes that the proposed minimum capital

requirement is reasonable related to the capital requirement for LMMs that are participating in the Book Pilot Program which the Commission recently approved. <sup>15</sup> Like the capital requirement for participants in the Book Pilot Program, the amount of capital an LMM is required to maintain in excess of the \$350,000 minimum will be determined based on the number of issues an LMM trades rather than on the constantly fluctuating price of the stock underlying an allocated issue. This method of determining the minimum capital required has the advantages of simplifying the capital calculations and preventing stock splits from significant reducing LMM capital requirements. <sup>16</sup>

#### B. Guaranteed Participation

The proposal amends PCX Rule 6.82(d)(2) to clarify the circumstances in which the Exchange may modify an LMM's guaranteed participation. Currently, an LMM's guaranteed participation may be reduced from 50% to 40% in a multiply-traded issue, and may be reduced from 50% to 25% in a non-multiply traded issue, if average daily trading volume in the issue reaches 2,000 contracts at the Exchange for "three consecutive months" (and other events occur). The proposal replaces the words "for three consecutive months" with the words "during any three-calendar-month period (measured on a 'rolling' three-calendar-month basis)" to clarify that the average daily trading volume requirement of 3,000 contracts is determined on an aggregate basis, and that 3,000 contracts need not be the average daily trading volume for every month in the applicable three-calendar-month period. <sup>17</sup>

For multiply-traded issues, PCX Rule 6.82(d)(2)(A) also requires that the Exchange's share of multi-exchange customer trading volume drop below a certain level before an LMM's guaranteed participation will be reduced. The proposal clarifies that the applicable customer trading volume

<sup>10</sup> Thus, for example, if trading volume in an issue reached an average of 2,000 contracts per day in the first month, 4,000 per day in the second month, and 4,000 per day in the third month, the condition would have been met under the proposed formulation, but not under the current formulation.

<sup>11</sup> The proposal states that in the case of an issue traded by two options exchanges, the Exchange's monthly share of the total multi-exchange customer trading volume must drop from above 70% to below 70%. In the case of an issue traded by three or more options exchanges, the Exchange's monthly share of the total multi-exchange customer trading volume must drop from above 45% to below 45%.

<sup>12</sup> 15 U.S.C. 78f(b).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> See letter from Michael D. Pierson, Senior Attorney, Pacific Exchange Inc., to Heidi Pilpel Special Counsel, Division of Market Regulation, SEC (August 31, 1998), representing, among other things that (i) as a business matter, the proposed capital requirement will assure that LMMs are capable of making deep, liquid and competitive markets; (ii) PCX Rule 6.36 requires each LMM to have a letter of guarantee from a clearing firm providing that the clearing firm accepts financial responsibility for all Exchange transactions made by the LMM, and (iii) it is the practice by the Exchange to evaluate the performance of each LMM every six months to identify any LMMs who may be trading too many issues to provide deep, liquid, and competitive markets.

<sup>15</sup> LMMs participating in the Book Pilot Program (who are responsible for the operation of the public limit order book and the resolution of trading errors committed in the course of operating the Book) are required to have minimum capital of \$500,000, plus \$25,000 for each issue over 5 issues included in the Book Pilot Program. The Commission recently approved this capital requirement. See Securities Exchange Act Release 39875 (April 15, 1998), 63 FR 19994 (April 22, 1998).

<sup>16</sup> See letter from Michael D. Pierson, Senior Attorney, Pacific Exchange Inc., to Heidi Pilpel Special Counsel, Division of Market Regulation, SEC (August 31, 1998), offering additional justifications for the proposed rule change.

<sup>17</sup> See footnote 10 *supra*.

levels are to be determined on a monthly basis.<sup>18</sup>

Additionally, the proposal codifies the Exchange's existing policy on when an LMM's guaranteed participation may return to 50% after having been reduced. The proposal provides that the Options Allocation Committee may in its discretion return an LMM to receiving a guaranteed 50% participation, after having had it reduced to 40% or 25%, if average daily trading volume in an issue falls below 3,000 contracts at the Exchange during any three-calendar-month period (measured on a 'rolling' three-calendar-month basis).

The Commission finds that the proposed rule changes relating to guaranteed participation are appropriate in that they reduce ambiguity and provide LMMs and the marketplace with clearer notice as to how an LMM's guaranteed participation will be determined.

#### IV. Conclusion

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

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

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

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40400; File No. SR-Phlx-98-36]

#### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to an Increase in Position and Exercise Limits for Standardized Equity Options

September 3, 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 August 14, 1998, 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. 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 Phlx proposes to amend Exchange Rule 1001, Position Limits, to increase position and exercise limits<sup>3</sup> for standardized equity options to three times their current levels. Corresponding changes are also being made to the equity option hedge exemption contained in Commentary .07 to Rule 1001.

#### 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 Phlx is proposing to increase the position and exercise limits for equity options traded on the Exchange to three times their current levels. Currently, Phlx Rule 1001 subjects equity options to one of the five different position limits depending on the trading volume and outstanding shares of the underlying security. Rule 1002 establishes corresponding exercises limits.<sup>4</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 contracts. Corresponding changes are also being proposed to the equity option hedge exemption contained in Commentary .07 of Rule 1001 so that the example in the Commentary reflects the proposed position and exercise limits. 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 Phlx 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 mini-manipulations and for corners or squeezes of the underlying market.<sup>5</sup>

At this time in 1998, noting 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, routine oversight inspections of Phlx's regulatory programs by the commission have not uncovered any material inconsistencies or shortcomings in the manner in which the Exchange's market surveillance reviews position limits.

another exchange if the member or member organization is not a member of that exchange) if as a result thereof such member or member organization, or partner, officer, director or employee thereof or customer, acting alone or in concert with others, directly or indirectly, has or will have exercised within any five (5) consecutive business days aggregate long positions in that class (put or call) as set forth in the position limit in Rule 1001, in the case of options on a stock, on a foreign currency or cross rate currency options, or stock index warrants; without regard to the exchange on which the options were purchased. Whether option or warrant positions should be aggregated under this rule shall be determined in the manner described in the Commentary to Exchange Rule 1001. Index option position and exercise limits are governed by Rules 1001A and 1002A."

<sup>5</sup> Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998).

<sup>18</sup> See footnote 11 *supra*.

<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</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> Position limits impose a ceiling on the number of option contracts in each class on the same side of the market relating to the same underlying security that can be held or written by an investor or group of investors acting in concert.

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 within five consecutive business days.

<sup>4</sup> Rule 1002 states ". . . no member or member organization shall exercise, for any account in which such member or member organization has an interest or for the account of any partner, officer, director or employee thereof or for the account of any customer, a long position in any option contract of a class of options dealt in on the Exchange (or, respecting an option not dealt in on the Exchange,