

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40584; File No. SR-CBOE-98-39]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by Chicago Board Options Exchange, Inc. Relating to Exercise Price Intervals for FLEX Equity Options

October 21, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on September 23, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" 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 CBOE. 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 Exchange proposes to delete Interpretation .01 of CBOE Rule 24A.4(c)(2).² This interpretation limits exercise price intervals and exercise prices for FLEX Equity call options to those that apply to Non-FLEX Equity call options.

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 CBOE 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 those statements may be examined at the places specified in Item IV below. The CBOE 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 purpose of the proposed rule change is to delete Interpretation .01 under CBOE Rule 24A.4(c)(2). This interpretation limits the exercise price intervals and exercise prices available for FLEX Equity call options to those intervals and prices that are available for Non-FLEX Equity call options pursuant to Interpretation and Policy .01 under CBOE Rule 5.5. This policy was intended to eliminate uncertainty concerning what constitutes a "qualified" covered call for certain purposes under the Internal Revenue Code pending clarification of this tax issue.

Currently, under Section 1092(c)(4)(B) of the Internal Revenue Code, certain covered short positions in call options qualify for advantageous tax treatment if the options are not in the money by more than a specified amount at the time they are written. One measure used to determine whether a call option is qualified is whether its exercise of "strike" price is no lower than the "lowest qualified benchmark price," which is generally the highest strike price available for trading that is less than the current price of the underlying stock. Since the exercise prices of FLEX³ Equity Options are not subject to the same intervals that apply to Non-FLEX Equity Options, this has raised the question whether the existence of a series of FLEX Equity Options with a strike price of, say, 58 when the price of the underlying stock is 59 would disqualify a Non-FLEX call option with a strike price of 55, which would otherwise be the highest strike price available that is less than the price of the stock.

The Internal Revenue Service ("IRS") has reviewed this issue and has a proposed regulation that would not require that strike prices established by equity options with flexible terms be taken into account in determining whether standard term equity options are too deep in the money to receive qualified covered call treatment.³ The public comment period for the proposed rule change closed on September 23, 1998⁴ and the Exchange expects final regulations on this topic to be adopted some time after that date. The Exchange intends for the deletion of Interpretation

.01 to coincide with the effective date of final regulations by the Internal Revenue Service. The effect of the IRS proposed rulemaking and the Exchange's proposed withdrawal of the limitation of the exercise price of Equity FLEX call options is that certain taxpayers, particularly institutional and other large investors, can engage in transactions in Equity FLEX call options with a wider range of exercise prices (as was originally intended) without affecting the applicability of Section 1092 of the Internal Revenue Code for qualified covered call options involving equity options with standard terms.

2. Statutory Basis

The proposed rule change, by eliminating a restriction on Equity FLEX call options which has restricted their usefulness as a risk managing mechanism, will remove impediments to and perfect the mechanism of a free and open market in FLEX Equity Options, and thus is consistent with the objectives of Section 6(b)(5) of the Act.⁵

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

The CBOE 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. 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 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 filing is consistent with the Act. Persons making

¹ 15 U.S.C. 78s(b)(1).

² This Interpretation was approved by the Commission in 1996. Securities Exchange Act Release No. 37726 (September 25, 1996), 61 FR 51474 (October 2, 1996).

³ Department of the Treasury, Internal Revenue Service REG-104641-97, 63 FR 34616 (June 25, 1998).

⁴ The IRS is holding a hearing on November 4, 1998 on the proposed rulemaking.

⁵ 15 U.S.C. 78f(b)(5).

written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 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. Copies of the filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-98-39 and should be submitted by November 19, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁶

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 98-28851 Filed 10-28-98; 8:45 am]

BILLING CODE 8010-01-M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40572; File No. SR-CBOE-98-41]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. to Amend Its Minor Rule Violation Plan With Respect to Exercise of American-Style, Cash-Settled Index Options

October 19, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 23, 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 CBOE. 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

CBOE proposes to amend its minor rule violation plan³ to include a schedule of summary fines for late exercise of cash-settled index options pursuant to CBOE Rule 11.1, Interpretation .03. 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, CBOE 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 Exchange 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

CBOE proposes to amend the summary fine rule to add a schedule of fines for CBOE members who violate provisions of Exchange Rule 11.1 governing the exercise of American-style, cash-settled index options. Currently, CBOE trades one American-style, cash-settled index option contract, Standard & Poor's 100 Index options ("OEX"). Examples of violations that would be subject to the summary fine are the failure to submit an exercise advice; the submission of advice and no subsequent exercise; the submission of an exercise advice after the designated cut-off time; the submission of an exercise advice for an amount different than the amount exercised; and the time-stamping of an advice or exercise instruction memorandum prior to purchasing contracts. Violations occurring on a single trade date will generally be treated as one occurrence.⁴

³ Rule 19d-1(c)(2) under the Act authorizes national securities exchanges to adopt minor rule violation plans for the summary discipline and abbreviated reporting of minor rule violations by exchange members and member organizations. See Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23828 (June 8, 1984) (order amending Rule 19d-1 under the Act).

⁴ For example, of on any given day an individual member submits an exercise advice late to the Exchange and on the same day subsequently exercises a larger number of contracts than noted

There are three reasons why the Exchange determined to propose this schedule of summary fines. First, the Exchange believes most violations are inadvertent. Second, processing routine violations under the summary fine program would significantly decrease the administrative burden of regulatory and enforcement staff as well as that of the BCC.⁵ Third, the membership of the Exchange would be more cognizant of the severity of penalties imposed and staff would be better able to expeditiously process routine violations under the summary fine program. The Exchange believes that the escalating schedule will deter members from considering fines for these violations as "the cost of doing business."

The summary fine schedule for Exchange Rule 11.1 violations, to be imposed on a rolling year look back period, is proposed to be as follows:

- *Violations No. 1 and 2*—Letter of Caution. However, if the violation involves 5 contracts or less and no unusual circumstances are noted, a Letter of Information will be issued. Letters of Information will not be counted for escalation purposes and a member cannot receive more than two Letters of Information during the rolling year look back period.
- *Violation 3*—Summary Fine of \$1,000 plus \$10 per contract.*
- *Violation 4*—Summary Fine of \$2,000 plus \$10 per contract.*
- *Violation 5*—Summary Fine of \$4,000 plus \$10 per contract.*
- *Violation 6 and Subsequent*—Referral to the BCC.

on the advice, both of these rule infractions (late advice submission and contract discrepancy) would be treated under the summary fine program as one violation. On the other hand, if two different market maker nominees of the same member firm each separately submit late exercise advices, such independent actions would be treated as two separate rule violations, even though they occurred on the same day. Where a matter is referred to the Business Conduct Committee ("BCC") for action, instead of being handled under the summary fine program, the BCC would not be precluded from handling similar fact patterns differently. Telephone conversation between May Bender, Senior Vice President, Regulation, CBOE, and Robert Long, Attorney, Division of Market Regulation, Commission, on September 24, 1998.

⁵ From January 1996 through May 1998, approximately 111 investigative reports were reviewed at the Pre-BCC level and resulted in the issuance of Letters of Caution. A total of 15 Statement of Charges were authorized and/or settled by the BCC during the same time period. Five of these violations could have been resolved via the proposed summary fine program. The remaining violations either involved significant fines or the dissemination of news. Under the proposed program, investigative reports will not be prepared describing violative conduct and presented to the BCC and/or Pre-BCC. Rather, upon receipt and review of all necessary documentation, the Letter of Caution or Summary Fine Disciplinary Notice will be immediately issued to the member.

⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.