

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 such filing will also be available for inspection and copying at the principal office of the BSE. All submissions should refer to File No. SR-BSE-98-13 and should be submitted by February 2, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40875; File Nos. SR-CBOE-98-25; Amex-98-22; PCX-98-33; and Phlx-98-36]

**Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Changes by the Chicago Board Options Stock Exchange, Inc., American Stock Exchange, Inc., Pacific Exchange, Inc., and Philadelphia Stock Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 1 and 2 by the Chicago Board Options Exchange; Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 by the American Stock Exchange; Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 by the Pacific Exchange; Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 1 and 2 by the Philadelphia Stock Exchange; Relating to an Increase in Position and Exercise Limits for Standardized Equity Options**

December 31, 1998.

### I. Introduction

On June 8, 1998, the Chicago Board Options Exchange, Inc. ("CBOE"); on June 24, 1998, the American Stock Exchange, Inc. ("Amex"); July 1, 1998, the Pacific Exchange, Inc. ("PCX"); and on August 14, 1998, the Philadelphia Stock Exchange, Inc. ("Phlx") (collectively, the "Exchanges"); submitted to the Securities and Exchange Commission ("SEC" or "Commission"), 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> proposed rule changes to increase position and exercise limits for standardized equity options to three times their current levels.

The proposed rule changes were published for comment in the **Federal Register** on July 9, 1998, July 9, 1998, July 14, 1998, and September 11, 1998.<sup>3</sup> CBOE filed two amendments to its proposed rule change, respectively on November 12 and November 18, 1998.<sup>4</sup> Amex filed an amendment to its proposed rule change on November 23, 1998.<sup>5</sup> PCX filed an amendment to its proposed rule change on December 14, 1998.<sup>6</sup> Phlx filed two amendments to its

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

<sup>3</sup> See Exchange Act Release Nos. 40160 (July 1, 1998), 63 FR 37155 (July 9, 1998) (CBOE); 40159 (July 1, 1998), 63 FR 37151 (July 9, 1998) (Amex); 40172 (July 6, 1998), 63 FR 37913 (July 14, 1998) (PCX); and 40400 (September 3, 1998), 63 FR 48777 (September 11, 1998) (Phlx).

<sup>4</sup> See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Timothy Thompson, CBOE, dated November 10, 1998 ("CBOE Amendment No. 1"). CBOE Amendment No. 1, in addition to making certain non-substantive changes, implements a new hedge reporting requirement with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. See also Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Timothy Thompson, CBOE, dated November 17, 1998 ("CBOE Amendment No. 2"). CBOE Amendment No. 2 clarifies that the 10,000 contract reporting requirement does not apply to CBOE market-maker accounts. The amendment provides that the Exchange has the authority to impose additional margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. CBOE Amendment No. 2 also clarifies that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule change.

<sup>5</sup> See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Scott G. Van Hatten, Legal Counsel, Amex, dated November 20, 1998 ("Amex Amendment No. 1"). Amex Amendment No. 1 implements a new hedge reporting requirement on members, other than exchange market-makers, with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. The amendment provides that the Exchange has the authority to impose additional margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. Amex Amendment No. 1 also clarifies that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule change.

<sup>6</sup> See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Robert Pacileo, Staff Attorney, PCX, dated December 14, 1998 ("PCX Amendment No. 1"). PCX Amendment No. 1, in addition to making technical language changes, implements a new hedge reporting requirement on members, other than exchange market-makers, with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. The amendment provides that the Exchange has the authority to impose additional

proposed rule change on September 15 and December 4, 1998.<sup>7</sup> One comment was received on the CBOE's proposal.<sup>8</sup> This order approves the proposals, as amended.

### II. Description

The Exchanges propose to increase position and exercise limits for standardized equity options<sup>9</sup> to three times their current levels.<sup>10</sup> The current position and exercise limits subject standardized equity options to one of five different position limits depending on the trading volume and outstanding share for the underlying security. 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 Exchanges believe sophisticated surveillance techniques at options exchanges adequately protect the

margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. PCX Amendment No. 1 also clarifies that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule change.

<sup>7</sup> See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Linda S. Christie, Counsel, Phlx, dated September 14, 1998 ("Phlx Amendment No. 1"). Phlx Amendment No. 1 makes minor technical changes by clarifying the new position limits in the examples presented in Commentary .08(a) of Phlx Rule 1001. See also Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from John Dayton, Phlx, dated December 3, 1998 ("Phlx Amendment No. 2"). Phlx Amendment No. 2, in addition to making certain non-substantive changes, implements a new hedge reporting requirement on members, other than exchange market-makers, with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. The amendment provides that the Exchange has the authority to impose additional margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. Phlx Amendment No. 2 also clarifies that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule change.

<sup>8</sup> See Letter to Jonathan G. Katz, Secretary, Commission, from Kathryn V. Natale, Deputy General Counsel/Director of Compliance-Americas, Credit Suisse First Boston, dated September 23, 1998 ("CSFB Letter"). The CSFB Letter generally supported the position and exercise limit increase.

<sup>9</sup> Standardized options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that have standard terms with respect to strike prices, expiration dates, and the amount of the underlying security.

<sup>10</sup> Position limits impose a ceiling on the aggregate number of option contracts on the same side of the market (i.e., aggregating long calls and short puts or long puts and short calls) that an investor, or a group of investors acting in concert, may hold or write. Exercise limits impose a ceiling on the aggregate long positions in option contracts that an investor, or group of investors acting in concert, can or will have exercised within five consecutive business days.

<sup>8</sup> 17 CFR 200.30-3(a)(12).

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

integrity of the markets for the options that will be subject to these increased position and exercise limits. The proposed rule change also will implement a new hedge reporting requirement on members, other than exchange market-makers, with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market.

### III. Discussion

The Commission finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of section 6 of the Act.<sup>11</sup> Specifically, the Commission believes that the proposed rule changes are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. The Commission also believes that the proposed rule changes are consistent with section 11A of the Act<sup>12</sup> in that they will enhance competition by allowing the Exchanges to compete better with the growing over-the-counter (OTC) market in customized equity options and with entities not subject to position limit rules.<sup>13</sup>

The Commission notes that the Exchanges believe that position and exercise limits, at their current levels, no longer serve their stated purpose. In the past, 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 manipulative 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>14</sup>

<sup>11</sup> See 15 U.S.C. 78f(b). In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with section 3 of the Act. *Id.* at 78c(f).

<sup>12</sup> See 15 U.S.C. 78k-1.

<sup>13</sup> In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with Section 3 of the Act. *Id.*, at 78c(f).

<sup>14</sup> See e.g., Exchange Act Release No. 33283 (December 3, 1993), 58 FR 65204 (December 13, 1993) (CBOE-93-43) (order approving an increase

Although the Commission does not agree with the Exchanges that position and exercise limits no longer serve their intended purpose, the Commission believes that it is appropriate at this time to allow for an increase in position and exercise limits. In making this determination, the Commission has been careful to balance two competing concerns when considering the appropriate level at which to set equity option position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market for the underlying security by acquiring and exercising a number of options contracts disproportionate to the deliverable supply and average trading volume of the underlying security. At the same time, the Commission has realized 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>15</sup>

In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. At this time, the Commission believes that an increase in position and exercise limits is appropriate for several reasons. First, the attributes of the exchange options markets include, among other things, 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. The high level of price and transaction transparency in the centralized exchange setting helps to deter illegal and manipulative trading activity. Furthermore, because OCC serves as the counter-party guarantor in every exchange-traded transaction, the potential for disruption to the market as a result of a customer acquiring and exercising a number of options contracts disproportionate to the deliverable supply is substantially reduced. Second, an increase in position and exercise limits could bring additional depth and liquidity to the listed options markets without significantly increasing concerns regarding intermarket manipulations or disruptions of the options or the underlying securities.

in position and exercise limits for standardized equity options).

<sup>15</sup> See H.R. Rep. No. IFC-3, 96th Cong., 1st Sess. At 189-91 (Comm. Print 1978).

Third, the Exchanges' surveillance programs and enhanced reporting procedures should detect and deter trading abuses that could arise from the tripling of the current limits. Currently, the Exchanges' member firms are required to report to the exchanges those accounts that, on the previous business day, maintained aggregate long or short positions on the same side of the market of 200 or more contracts of any single class of options, identify the number of option contracts comprising each position and, in the case of short positions, state whether they are covered or uncovered (referred to as the "Large Options Position Report" or "LOPR"). The submission of specific information relating to hedged positions currently is not required but can be obtained upon request. In order to better monitor potentially large unhedged options positions that will be subject to significantly higher position limits, the Exchanges are adopting an additional reporting requirement and position monitoring program. The Exchanges have proposed to implement a new reporting requirement with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market.<sup>16</sup> Member firms will be required to report and update hedging information concerning the position, including a detailed description of the hedge employed. The Commission believes that this reporting requirement provides an additional flag to the Exchanges concerning accounts maintaining large positions. Receipt and review of this information will enable the Exchanges to better assess whether the account is properly hedged, whether additional margin should be imposed, or whether other regulatory action by the Exchange is necessary. Furthermore, large stock holdings must be disclosed to the Commission by way of Schedule 13D or 13G.<sup>17</sup> Options positions are part of any reportable positions and cannot be legally hidden.

Fourth, the Commission believes that financial requirements imposed by each Exchange and by the Commission

<sup>16</sup> The Amex requested that the reporting level being adopted be revised from 10,000 contracts to in excess of 13,500 contracts. The Amex believes that the reporting obligations and the requisite analyses at the 10,000 contract reporting level will require the Amex to analyze positions in a large number of accounts holding between 10,000 and 13,500 contracts, but that in nearly every case could permissibly hold at least 25,000 unhedged option contracts. See Letter to Michael Walinskas, Deputy Associate Director, Division of Market Regulation, Commission, from Scott G. Van Hatten, Legal Counsel, Amex, dated December 4, 1998. The Commission has determined that the 10,000 contract reporting level is appropriate at this time.

<sup>17</sup> Exchange Act Rule 13d-1.

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. The Exchanges also have the authority under their respective rules 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. 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 an additional form of protection.<sup>18</sup>

Fifth, an increase in position and exercise limits should attract business back from the less-transparent OTC market to the Exchanges where the trades will be subject to reporting requirements and surveillance. Exchange member firms have repeatedly expressed their belief that position limits 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.<sup>19</sup> The increase in position and exercise limits for standardized equity options should allow the Exchanges to better compete with the growing OTC market in customized equity options, thereby encouraging fair competition among brokers and exchange markets.

The Commission observes that CSFB, the sole commenter on the proposals, generally favors the increase in position and exercise limits. CSFB believes, however, that the current five-tier position limit system should be consolidated into a three-tier system. CSFB believes that consolidation of the position limit tiers would simplify the monitoring of options positions and reduce confusion for options traders and compliance personnel. The Commission notes that the Exchanges' proposed rule changes did not propose to consolidate the position limit tiers. Specifically, the

Exchanges did not seek to amend their respective proposals in response to the comment letter. Nevertheless, the Commission recognizes that the comment may have merit and that the Exchanges may consider to incorporate the views contained in the comment letter in future rule proposals.

The Commission finds good cause to approve Phlx Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Phlx Amendment No. 1 corrects a rule language oversight in Phlx's filing. Specifically, Phlx Amendment No. 1 makes minor technical changes by clarifying the new position limits in the examples presented in Commentary .08(a) of Phlx Rule 1001. Accordingly, the Commission believes that it is consistent with section 6(b) of the Act to approve Phlx Amendment No. 1 to the proposed rule change on an accelerated basis.

The Commission finds good cause to approve Amex Amendment No. 1, PCX Amendment No. 1, and Phlx Amendment No. 2 to the proposed rule changes prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amex Amendment No. 1, PCX Amendment No. 1, and Phlx Amendment No. 2 implement a new hedge reporting requirement on members, other than exchange market-makers, with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. The amendments provide that the Exchanges have the authority to impose additional margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. These amendments also clarify that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule changes. The Commission believes that receipt and review of this hedging information at the 10,000 contract threshold will enable the Exchanges to better assess whether an account is properly hedged, whether additional margin should be imposed, or whether other regulatory action by the Exchange is necessary. Furthermore, the clarification as to the reporting threshold for FLEX equity options helps to avoid an inadvertent increase in this threshold as a result of approving the current proposed rule changes. Accordingly, the Commission believes that it is consistent with section 6(b) of the Act to approve Amex

Amendment No. 1, PCX Amendment No. 1, and Phlx Amendment No. 2 to the proposed rule changes on an accelerated basis.

The Commission finds good cause to approve CBOE Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. CBOE Amendment No. 1, in addition to making certain non-substantive changes, implements a new hedge reporting requirement with respect to customer accounts holding an equity option position in excess of 10,000 contracts on the same side of the market. The Commission believes that receipt and review of this hedging information at the 10,000 contract threshold will enable the Exchange to better assess whether an account is properly hedged, whether additional margin should be imposed, or whether other regulatory action by the Exchange is necessary. Accordingly, the Commission believes that it is consistent with section 6(b) of the Act to approve CBOE Amendment No. 1 to the proposed rule change on an accelerated basis.

The Commission finds good cause to approve CBOE Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. CBOE Amendment No. 2 clarifies that the 10,000 contract reporting requirement does not apply to CBOE market-maker accounts. This clarification is consistent with the rules of other exchanges. The amendment provides that the Exchange has the authority to impose additional margin on the clearing firm carrying the subject customer account in the event an under-hedged equity option position in excess of 10,000 contracts is noted. CBOE Amendment No. 2 also clarifies that the reporting threshold for FLEX equity options will remain unchanged upon the Commission's approval of the current proposed rule change. This clarification helps to avoid an inadvertent increase in the FLEX equity reporting threshold as a result of approving the current proposed rule change. Accordingly, the Commission believes that it is consistent with section 6(b) of the Act to approve CBOE Amendment No. 2 to the proposed rule change on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six

<sup>18</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>19</sup> See, e.g., CSFB Letter.

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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File Nos. SR-CBOE-98-25; Amex-98-22; PCX-98-33; and/or Phlx-98-36 and should be submitted by February 2, 1999.

## V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>20</sup> that the proposed rule changes (SR-CBOE-98-25; SR-AMEX-98-22; SR-PCX-98-33; and SR-Phlx-98-36) are approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

[FR Doc. 99-594 Filed 1-11-99; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40868; File No. SR-CHX-98-33]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to the Trading of Nasdaq/NM Securities on the CHX

December 31, 1998.

On December 21, 1998 the Chicago Stock Exchange Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> the proposed rule change as described in Items I and II 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 and to grant accelerated approval of the proposed rule change.

### I. Self-Regulatory Organizations Statement of the Terms of Substance of the Proposed Rule Change

The Exchange hereby requests a six month extension of the pilot program relating to the trading of Nasdaq/NM Securities on the Exchange that is currently due to expire on December 31, 1998. Specifically, the pilot program amended Article XX, Rule 37 and Article XX, Rule 43 of the Exchange's Rules and the Exchange proposes that the amendments remain in effect on a pilot basis through June 30, 1999.

### 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 III 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 May 4, 1987, the Commission approved certain Exchange rules and procedures relating to the trading of Nasdaq/NM securities on the Exchange.<sup>2</sup> Among other things, these

<sup>2</sup> See Securities Exchange Act Release No. 24424 (May 4, 1987), 52 FR 17868 (May 12, 1987) (order approving File No. SR-MSE-87-2). See also Securities Exchange Act Release Nos. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (order expanding the number of eligible securities to 100); and 36102 (August 14, 1995), 60 FR 43626 (August 22, 1995) (order expanding the number of eligible securities to 500). The Commission notes that the CHX commented on the July 1998 extension order of the OTC-UTP Plan (Securities Exchange Act Release No. 40151 (July 1, 1998) 63 FR 36979 (July 8, 1998)) requesting an expansion of the number of Nasdaq/NM securities eligible to be traded on an unlisted basis on an exchange, from 500 to 1000, pursuant to the Plan. See Letter from George T. Simon, Foley & Lardner, to Robert L.D. Colby, Deputy Director, Division of Market Regulation ("Division"), SEC, dated November 6, 1998. The CHX believes that investors are directly benefited from trading Nasdaq/NM securities on the CHX floor because it provides investors with auction-based trading, including unified opening transactions, in Nasdaq/NM securities. In addition, the CHX represents that it has assigned virtually all of its current allocation of 500 Nasdaq/NM securities. The Commission solicited comments on

rules made the Exchange's BEST Rule guarantee (Article XX, Rule 37(a)) applicable to Nasdaq/NM securities and made Nasdaq/NM securities eligible for the automatic execution feature of the Exchange's Midwest Automated Execution System ("MAX system").<sup>3</sup>

On January 3, 1997, the Commission approved,<sup>4</sup> on a one year pilot basis, a program that eliminated the requirement that CHX specialists automatically execute orders in Nasdaq/NM securities when the specialist is not quoting at the national best bid or best offer ("NBBO").<sup>5</sup> When the Commission approved the program on a pilot basis, it stated that the arrangement in place for Exchange Specialists to access over-the-counter ("OTC") market makers was not an ideal linkage between the markets on a permanent basis and that the Exchange should work with Nasdaq to establish a more effective linkage. In addition, the Commission requested that the Exchange submit a report to the Commission describing the Exchange's experience with the pilot program. The Commission stated that the report should include at least six months worth of trading data. Due to programming issues, the pilot program was not implemented until April, 1997.

Six months of trading data did not become available until November, 1997. As a result, the Exchange requested an additional three month extension to collect the data and prepare the report for the Commission. On December 31, 1997, the Commission extended the pilot program for an additional three months, until March 31, 1998, to give the Exchange additional time to prepare and submit the report and to give the Commission adequate time to review the report prior to approving the pilot on a permanent basis.<sup>6</sup> The Exchange submitted the report to the Commission on January 30, 1998.

The Exchange, prior to the pilot expiring, requested another three month extension. On March 31, 1998, the Commission approved the pilot for an

the CHX request in the December 1998 extension order of the OTC-UTP Plan (Securities Exchange Act Release No. 40869 (December 31, 1998)).

<sup>3</sup> The MAX system may be used to provide an automated delivery and execution facility for orders that are eligible for execution under the Exchange's BEST Rule and certain other orders. See CHX, Art. XX, Rule 37(b). A MAX order that fits under the BEST parameters is executed pursuant to the BEST Rule via the MAX system. If an order is outside the BEST parameters, the BEST Rule does not apply, but MAX system handling rules do apply.

<sup>4</sup> See Securities Exchange Act Release No. 38119 (January 3, 1997) 62 FR 1788 (January 13, 1997) ("January 1997 Order").

<sup>5</sup> The NBBO is the best bid or offer disseminated pursuant to Rule 11Ac1-1 under the Act.

<sup>6</sup> See Securities Exchange Act Release No. 39512 (December 31, 1997), 63 FR 1517 (January 9, 1998).

<sup>20</sup> 15 U.S.C. 78s(b)(2).

<sup>21</sup> 17 CFR 200.30-3(a)(12).

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