

comprising the collar in excess of the applicable basic position limit (*i.e.*, 4,500) must be hedged on a one-for-one basis with 450,000 shares. The total number of allowable option contracts on the same side of the market in this example would be 13,500.

B. An investor is short 1,000 calls. The investor may establish an OTC collar consisting of 6,250 short calls and 6,250 long puts. Pursuant to proposed Section 33(b)(3)(A)(6)(b)(6), the options comprising the collar in excess of the applicable basic position limit (*i.e.*, 4,500) must be hedged on a one-for-one basis with 450,000 shares. The total number of allowable option contracts on the same side of the market in this example would be 13,500.

C. An investor is short 6,500 calls (4,500 pursuant to the position limit and 2,000 pursuant to the hedge exemption) and long 200,000 shares of stock. An OTC collar consisting of 2,500 short calls and 2,500 long puts may be established. Pursuant to proposed Section 33(b)(3)(A)(6)(b)(6), the options comprising the collar in excess of the applicable basic position limit (*i.e.*, 4,500) must be hedged on a one-for-one basis with an additional stock position of 250,000 shares. The total number of allowable option contracts on the same side of the market in this example would be 11,500.

D. An investor is short 9,000 calls (4,500 pursuant to the position limit and 4,500 pursuant to the hedge exemption) and long 450,000 shares of stock. An OTC collar may not be established since the investor has already reached the maximum allowable position limit.

### III. Commission Findings and Conclusions

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, in particular, the requirements of Section 6(b)(5) of the Act. Specifically, the Commission believes the conditions and limitations contained in the proposal strike a reasonable balance between the need to facilitate legitimate hedging needs of market participants and the need to have rules in place that do not compromise the regulatory purposes served by the equity option position limit rules. In particular, because the conditions and limitations for the OTC Collar Aggregation Exemption effectively provide that neither leg of the OTC collar can be in-the-money at the time the collar is established and that no more than one leg of the collar can ever be exercised throughout the term of the collar, the Commission does not believe that the larger options position resulting from the proposed non-aggregation of short (long) calls and long (short) puts for the hedge exemption portion of the position limit pursuant to the OTC Collar Aggregation

Exemption will increase the potential for market manipulation or disruption.<sup>11</sup>

In addition, even though the conventional options positions involved in a particular OTC collar transaction do not have to be aggregated (if the collar meets the standards for the aggregation exemption), the collar position must be aggregated with all other standardized and conventional options on the same side of the market overlying the same security. In this respect, the Commission notes that while the NASD's proposal does not change the recognized position limit levels (*i.e.*, 4,500, 7,500, 10,500), it does alter the manner in which contracts are aggregated for position limits purposes, with the net result being an increase in certain situations in the number of contracts an investor may hold on the same side of the market from 9,000 to 13,500 (assuming a position limit of 4,500). While the maximum number of contracts an investor may hold is effectively increased, the proposal's requirements ensure that the amount of stock that may be controlled by an investor's option position is not increased. Instead, the proposal merely facilitates the use of an OTC collar by not aggregating the positions for determining the number of contracts pursuant to the hedge exemption. To the extent that investors have greater latitude to use a collar for hedging purposes, the proposal will enhance investors' risk management of stock positions.<sup>12</sup>

The Commission also believes that the larger options positions available by virtue of the proposal will not result in disruptions to the underlying stock market due to the conditions and limitations that must be met to be eligible for the aggregation exemption, and the NASD's surveillance program. In this connection, the Commission notes the NASD will monitor the use of the OTC Collar Aggregation Exemption to ensure that NASD members are complying with the requirements of the exemption.

The Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in

<sup>11</sup> Furthermore, in order to ensure that the positions covered by this proposal are maintained in a collar transaction, the proposal requires that all of the conventional options comprising the OTC collar must be European-style and expire on the same date.

<sup>12</sup> As noted above, the non-aggregation of collar positions only applies to positions established pursuant to the existing hedge exemption. See *supra* note 10.

the **Federal Register**. Amendment No. 2 has the effect of limiting and clarifying the maximum number of contracts that may comprise a particular OTC collar established pursuant to the OTC Collar Aggregation Exemption, and as a result, should further reduce any speculative or manipulative impact caused by the net increase in the number of options held by an investor. Therefore, the Commission believes there is good cause to approve Amendment No. 2 to the proposal on an accelerated basis.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2. 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. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by July 19, 1995.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>13</sup> that the proposed rule change (SR-NASD-94-60) is approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>14</sup>

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

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[Release No. 34-35875; File No. SR-NASD-95-27]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Adjustment of Open Orders

June 21, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

<sup>13</sup> 15 USC 78s(b)(2) (1988).

<sup>14</sup> 17 CFR 200.30-3(a)(12) (1994).

("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on June 19, 1995,<sup>1</sup> the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or Commission) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. 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 NASD is proposing to amend Article III, Section 46 of the Rules of Fair Practice to provide that where the issuer of a security declares a cash dividend or other distribution of less than one cent (\$.01) members will not adjust open orders for such securities. Below is the text of the proposed rule change. Proposed new language is italics.

#### **Rules of Fair Practice**

##### *Article III*

##### Adjustment of Open Orders

#### **Sec. 46.**

(a) A member holding an open order from a customer or another broker/dealer shall, prior to executing or permitting the order to be executed, reduce, increase or adjust the price and/or number of shares of such order by an amount equal to the dividend, payment or distribution, on the day that the security is quoted ex-dividend, ex-rights, ex-distribution or ex-interest, *except where a cash dividend or distribution is less than one cent (\$.01)*, as follows:

(i) In the case of a cash dividend or distribution, the price of the order shall be reduced by subtracting the dollar amount of the dividend or distribution from the price of the order and rounding the result to the next lower  $\frac{1}{8}$  of a dollar;

(ii) In the case of a stock dividend or split, the price of the order shall be reduced by rounding the dollar value of the stock dividend or split to the next higher  $\frac{1}{8}$  of a dollar and subtracting that amount from the price of the order; provided, further, that the size of the order shall be increased by (1) multiplying the size of the original order by the numerator of the ratio of the dividend or split, (2) dividing the result

by the denominator of the ratio of the dividend or split, and (3) rounding the result to the next lower round lot; and

(ii) In the case of a dividend payable in either cash or securities at the option of the stockholder, the price of the order shall be reduced by the dollar value of the cash or securities, whichever is greater, according to the formulas in (a)(i) or (a)(ii), above; provided, that if the stockholder opts for securities, the size of the order shall be increased pursuant to the formula in (a)(ii), above.

### **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 NASD 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 NASD 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*

Article III, Section 46 of the Rules of Fair Practice requires members holding open orders to proportionally reprice such orders according to the value of the dividend or distribution on the date the security is quoted ex-dividend, ex-rights, ex-distribution or ex-interest. Shortly after the rule became effective in September 1994, several member firms questioned the necessity of complying with Section 46 if a dividend or other distribution was less than one cent (\$.01).

The NASD has examined the matter and determined that where dividends of less than one cent (\$.01) are involved inefficiencies and costs associated with complying with Section 46 may exceed any benefit to be gained. The impact of such a small dividend on the price of the security is probably *de minimis* in nature and the likelihood that unadjusted orders will result in bad executions for customers is low.

Accordingly, the NASD is proposing to amend Section 46 to state that where a dividend or other distribution is less than one cent (\$.01) the price of the order shall not be adjusted.

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the

Act<sup>2</sup> in that the elimination of the costs and inefficiencies associated with mandating the repricing of orders where the dividend or distribution is less than one cent (\$.01) will refine the functioning of Section 46 to the benefit of the market and investors.

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

The NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments 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 (iii) 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. 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. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All

<sup>1</sup> The NASD originally submitted the proposed rule change on May 23, 1995. On June 19, 1995, the NASD submitted Amendment No. 1 which amendment made technical changes to the proposal.

<sup>2</sup> 15 U.S.C. 78o-3

submissions should refer to File Number SR-NASD-95-27 and should be submitted by July 19, 1995.

For the Commission, by the Division of Market Regulation, pursuant to the delegated authority.<sup>3</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35877; File No. SR-NASD-95-28]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Trading in Anticipation of the Issuance of a Research Report**

June 21, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on May 25, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. 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**

Pursuant to the provisions of Section 19(b)(1) of the Act, the NASD hereby proposes to amend Article III, Section 1 of the NASD Rules of Fair Practice<sup>1</sup> by adding a new Interpretation regarding a prohibition against purposeful trading that affects a member firm's inventory position in a given security prior to the firm's issuance of a research report in that same security. Below is the text of the proposed rule change. Proposed new language is in italics.

**Trading Ahead of Research Reports Interpretation to Article III, Section 1 of the NASD Rules of Fair Practice**

*The Board of Governors, under its statutory obligation to protect investors and enhance market quality, is issuing an Interpretation to the Rules of Fair Practice regarding a member firm's trading activities that occur in anticipation of a firm's issuance of a research report regarding a security. The Board of Governors is concerned with*

*activities of member firms that purposefully establish or adjust firm's inventory position in Nasdaq-listed securities, an exchange-listed security traded in the OTC market, or a derivative security based primarily on a specific Nasdaq or exchange-listed security in anticipation of the issuance of a research report in that same security. For example, a firm's research department may prepare a research report recommending the purchase of a particular Nasdaq-listed security. Prior to the publication and dissemination of the report, however, the trading department of the member firm might purposefully accumulate a position in that security to meet anticipated customer demand for that security. After the firm had established its position, the firm would issue the report, and thereafter fill customer orders from the member firm's inventory positions.*

*The NASD believes that such activity is conduct which is inconsistent with just and equitable purposes of trade, and not in the best interests of investors. Thus, this Interpretation prohibits a member from purposefully establishing, creating or changing the firm's inventory position in a Nasdaq-listed stock, and exchange-listed stock traded in the third market, or a derivative security related to the underlying equity security, in anticipation of the issuance of a research report regarding such security by the member firm.*

*Article III, Section 1 of the Rules of Fair Practice states that:*

*A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.*

*In accordance with Article VII, Section 1(a)(2) of the NASD By-laws, the NASD Board of Governors has approved the following Interpretation of Article III, Section 1:*

*Trading activity purposefully establishing, increasing, decreasing, or liquidating a position in a Nasdaq security, an exchange-listed security traded in the over-the-counter market, or a derivative security based primarily upon a specific Nasdaq or exchange-listed security, in anticipation of the issuance of a research report in that security is inconsistent with just and equitable principles of trade and is a violation of Article III, Section 1 of the Rules of Fair Practice.*

*For the purposes of this Interpretation, a "purposeful" change in the firm's inventory position means any trading activities undertaken with the intent of altering a firm's position in a security in anticipation of accommodating investor interest once*

*the research report has been published. Hence, the Interpretation does not apply to changes in an inventory position related to unsolicited order flow from a firm's retail or broker-dealer client base or to research done solely for in-house trading and not in any way used for external publication.*

*Under this Interpretation, the Board recommends, but does not require, that member firms develop and implement policies and procedures to establish effective internal control systems and procedures that would isolate specific information within research and other relevant departments of the firm so as to prevent the trading department from utilizing the advance knowledge of the issuance of a research report. Firms that choose not to develop "Chinese Wall" procedures bear the burden of demonstrating that the basis for changes in inventory positions in advance of research reports was not purposeful.*

**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 NASD 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 NASD 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*

(a) Background

At times, broker-dealers that have research departments prepare research reports that recommend that customers take certain actions with respect to certain identified securities. The research reports may advise the firm's customers to buy or sell the security that is the subject of the research report. For instance, prior to publication of a research report, some firms would intentionally establish a proprietary position in the security that was to be the subject of a report in anticipation of meeting expected customer demand in response to the research report. Once the firm had accumulated stock, it would issue the research report and commence solicitation of orders, expecting to fill customer orders from the inventory position it had accumulated.

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

<sup>1</sup> NASD Manual, Rules of Fair Practice, Art. III, Sec. 1 (CCH) ¶ 2151.