

techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted in writing within 60 days of this publication.

Direct your written comments to Michael E. Bartell, Associate Executive Director, Office of Information Technology, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

Dated: January 5, 1996.

Margaret H. McFarland,  
Deputy Secretary.

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[Release No. 34-36710; File Nos. SR-Amex-94-56, SR-CBOE-95-14, and SR-PSE-95-01]

**Self-Regulatory Organizations; American Stock Exchange, Inc.; Chicago Board Options Exchange, Inc.; and Pacific Stock Exchange, Inc.; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendments Thereto Relating to Buy-Write Option Unitary Derivatives ("BOUNDS")**

January 11, 1996.

Pursuant to Section 19(b) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> the American Stock Exchange, Inc. ("Amex"), Pacific Stock Exchange, Inc. ("PSE"), and Chicago Board Options Exchange, Inc. ("CBOE") (collectively, the "Exchanges") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), proposed rule changes ("proposals") to permit trading in Buy-Write Options Unitary Derivatives ("BOUNDS").<sup>3</sup>

Notice of the proposed rule changes and Amex Amendment No. 1 were published for comment and appeared in the Federal Register.<sup>4</sup> Two comment

letters were received in response to the Amex proposal,<sup>5</sup> and one letter was submitted in response to the CBOE and PSE proposals.<sup>6</sup> The Amex responded to both comment letters.<sup>7</sup>

The Amex subsequently submitted Amendments No. 2 and 3 to the proposal on December 19, 1996 ("Amex Amendment No. 2") and January 11, 1995 ("Amex Amendment No. 3").<sup>8</sup> The CBOE subsequently submitted Amendment No. 1 ("CBOE Amendment No. 1") to the proposal on January 4, 1996.<sup>9</sup> The PSE subsequently submitted Amendments No. 1, 2, and 3 to the proposal on June 27, 1995 ("PSE Amendment No. 1"), January 2, 1996 ("PSE Amendment No. 2"), and January 4, 1996, respectively ("PSE Amendment No. 3") (collectively, with all of the Exchanges' amendments, the "Amendments").<sup>10</sup>

Amex and PSE Amendments No. 2 and CBOE Amendment No. 1 primarily relate to the elimination of certain spread margin treatment provisions and the conforming of the Exchanges' rules to those of the Options Clearing Corporation ("OCC") in order to avoid potential conflict. In addition, Amex Amendment No. 2 and CBOE Amendment No. 1 also clarify that their respective "ten-up rules" (Amex Rule 958A and CBOE Rule 8.51) will not be applicable to the trading of BOUNDS. Amex and PSE Amendments No. 3 and CBOE Amendment No. 1 eliminate the use of escrow receipts and letters of guarantee as adequate margin cover for short BOUNDS positions. Finally, PSE Amendment No. 1 establishes that BOUNDS are designated as Tier I securities for purposes of PSE Rule 3.

1995) (CBOE); and 35436 (March 2, 1995), 60 FR 12998 (March 9, 1995) (PSE).

<sup>5</sup> See Letters to Jonathan G. Katz, Secretary, SEC, from James E. Buck, Senior Vice President and Secretary, NYSE, dated February 27, 1995; and Carl F. Koenemann, Executive Vice President and Chief Financial Officer, Motorola, Inc., dated March 1, 1995.

<sup>6</sup> See Letter from James E. Buck, Senior Vice President and Secretary, NYSE, dated March 15, 1995 to Jonathan G. Katz, Secretary, SEC. This letter incorporates the same comments raised by the NYSE in response to the Amex proposal.

<sup>7</sup> See Letter from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Stephen Youhn, Esq., Derivative Products Regulation, SEC, dated March 21, 1995.

<sup>8</sup> See Letters from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Michael Walinskas, Derivative Products Regulation, SEC dated December 15, 1995 and to Stephen Youhn, SEC, dated January 11, 1996, respectively.

<sup>9</sup> See Letter from Janet Angstadt, Schiff Hardin & Waite, to Michael Walinskas, SEC, dated January 4, 1996.

<sup>10</sup> See Letters from Michael Pierson, Senior Attorney, PSE, to Stephen M. Youhn, SEC, dated June 20, 1995, December 29, 1995, and January 3, 1996, respectively.

This order approves the proposals, as amended.

**I. Description of the Proposal**

The Exchanges, for some time, have sought a replacement for the expired Americus Trust PRIMES and SCOREs ("PRIMEs and SCOREs").<sup>11</sup> During this process, the Exchanges began to list and trade a standardized option product called LEAPs. Like SCOREs, LEAPs enable investors to receive the benefits of a stock's price appreciation above a fixed dollar amount over a long period of time. Currently, however, there is no generally available replacement for the PRIMEs component.

The Exchanges, accordingly, propose to list BOUNDS as a replacement for PRIMEs. BOUNDS will offer essentially the same economic characteristics as covered calls with the added benefits that BOUNDS can be traded in a single transaction and are not subject to early exercise. BOUND holders will profit from appreciation in the underlying stock's price up to the strike price until expiration and will receive payments equivalent to any cash dividends declared on the underlying stock. As with PRIMEs, the strike price will serve as a "cap" to effectively limit the amount of upside appreciation an investor may receive.

OCC will be the issuer of all BOUNDS traded on the Exchanges, which are proposed to be treated as standardized options pursuant to Rule 9b-1 of the Act ("Rule 9b-1").<sup>12</sup> As with all OCC issued options, BOUNDS will be created when an opening buy or an opening sell order are executed and the execution of such orders will increase the open interest in BOUNDS. On the dividend payable date for the underlying stock, OCC will debit all accounts with short positions in BOUNDS and credit all accounts with long positions in BOUNDS with an amount equal to the cash dividend on the underlying stock.<sup>13</sup> Except as described herein, BOUNDS will be subject to the rules governing standardized options.

The Exchanges anticipate listing BOUNDS on those underlying securities that have listed LEAPs. The criteria for stocks underlying BOUNDS will be same

<sup>11</sup> PRIMEs and SCOREs were unit investment trusts that allowed investors to separate their common stock securities holdings into distinct trading components representing discrete interests in the income and capital appreciation potential of the securities deposited in the trust. See Securities Exchange Act Release No. 21863 (March 18, 1985), 50 FR 11972 (March 26, 1985) ("PRIMEs Adopting Release").

<sup>12</sup> 17 CFR 240.9b-1 (1994).

<sup>13</sup> See Amex and PSE Amendments No. 2 and CBOE Amendment No. 1.

<sup>1</sup> 15 U.S.C. § 78s(b)(1) (1988 & Supp. V 1993).

<sup>2</sup> 17 CFR 240.19b-4 (1994).

<sup>3</sup> The Amex, CBOE, and PSE rule filings were submitted on December 12, 1994, February 1, 1995, and February 6, 1995, respectively. On December 23, 1994, the Amex submitted Amendment No. 1 ("Amex Amendment No. 1") to its filing to provide that BOUNDS will be listed with a maximum expiration date corresponding to the longest prescribed long-term equity options ("LEAPs") then available for trading, which is currently 39 months. See Letter from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Michael Walinskas, Derivative Products Regulation, SEC, dated Dec. 23, 1994. The Amex originally proposed listing BOUNDS with 60 month expirations and extending the maximum duration of LEAPs from 39 months to 60 months.

<sup>4</sup> See Securities Exchange Act Release Nos. 35327 (Feb. 3, 1995), 60 FR 7805 (Feb. 9, 1995) (Amex); 35430 (March 2, 1995), 60 FR 12991 (March 9,

as the criteria for stocks underlying LEAPs.<sup>14</sup>

The Exchanges also anticipate that the sum of the market prices of a LEAP and a BOUND on the same underlying stock with the same expiration and exercise price will closely approximate the market price for the underlying stock. The Exchanges further believe that certain BOUNDS-related arbitrage strategies will help to ensure this price relationship with the underlying security. Nevertheless, the Exchanges will conduct surveillance of BOUNDS in the same manner it surveils listed equity options.<sup>15</sup>

BOUNDS will have the same expiration dates as their respective LEAPs, however, the Exchanges will list only strike prices that are the same or very close to the price of the underlying stock at the time of listing, or that are below the price of the stock at that time. For example, at the time of initial listing, the strike prices for a BOUND with the underlying stock trading at \$50 per share, would be set at \$40 and \$50. An Exchange would not list a BOUND with a strike price of \$60 in this example.

The Exchanges anticipate listing new complementary LEAPs and BOUNDS on the same underlying securities annually, or at more frequent intervals, depending on market demand. The Exchanges have the current authority to list LEAPs with up to 39 months until expiration and, therefore, seek to introduce BOUNDS with up to the same 39 month duration.<sup>16</sup>

Like regular options, BOUNDS will trade in standardized contract units of 100 shares of underlying stock per BOUND so that at expiration, BOUND holders will receive 100 shares of the underlying stock for each BOUND contract held if, on the last day of trading, the underlying stock closes at or below the strike price. However, if at expiration the underlying stock closes above the strike price, the BOUNDS contract holder will receive a cash payment equal to 100 times the BOUND's strike price for each BOUND contract held. BOUND writers, depending on the price of the underlying stock at expiration, will be required to deliver either 100 shares of the underlying stock for each BOUND contract (if the price of the underlying stock is at or less than the strike price) or the strike price multiplied by 100 at

expiration (if the price of the underlying exceeds the strike price). This settlement design, from the perspective of the long BOUNDS holder, is economically similar to the situation where an investor purchases a covered call (*i.e.*, long stock, short call) and holds that position to the expiration of the call option.

For example, if the XYZ BOUND has a strike price of \$50 and XYZ stock closes at \$50 or less at expiration, the holder of the XYZ BOUND contract will receive 100 shares of XYZ stock. This is the same result as if the call option in a covered call position had expired out of the money; *i.e.*, the option would expire worthless and the writer would retain the underlying stock. If XYZ closes above \$50 per share, then the holder of an XYZ BOUND will receive \$5,000 in cash (100 times the \$50 strike price). This mimics the economic result to the covered call writer when the call expires in the money.

The settlement mechanism for the BOUNDS will operate in conjunction with that of LEAP calls. For example, if at expiration the underlying stock closes at or below the LEAP strike price, the LEAP call will expire worthless, and the holder of a corresponding BOUND contract will receive 100 shares of stock from the short BOUND. If, on the other hand, the LEAP call is in the money at expiration, the holder of the LEAP call is entitled to 100 shares of stock from a short LEAP upon payment of the proper exercise amount, and the holder of a BOUND contract is entitled to the cash equivalent of the strike price times 100 from the short BOUND. An investor long both a LEAP and a BOUND, where XYZ closes above the \$50 strike price at expiration, would be entitled to receive \$5,000 in cash from the short BOUND and, upon exercise of the LEAP, would be obligated to pay \$5,000 to receive 100 shares of XYZ stock.

An investor long the underlying stock, and who writes both a LEAP and a BOUND, will be obligated to deliver the stock to the long LEAP call if the underlying stock closes above the strike price, in exchange for payment of the strike price times 100, which amount will then be delivered to the long BOUND. Accordingly, the Exchanges believe a covered BOUND/LEAP writer's position is effectively closed upon the delivery of the underlying stock. If a writer of both instruments has deposited cash or securities other than the underlying stock as margin for a short LEAP call and BOUND, then the BOUND/LEAP writer delivers 100 shares of stock (purchased on the open market) to the long LEAP call upon payment of the strike price times 100.

The writer of the BOUND then delivers the cash value of 100 times the strike price to the holder of the long BOUND.

It should be noted that LEAPs are American-style options whereas BOUNDS are European-style.<sup>17</sup> The Exchanges believe that it would be inappropriate for the BOUND holder to have an American-style exercise right since the BOUND will tend to trade at a discount to the price of the underlying stock and BOUND strike price.

#### *Sales Practices*

BOUNDS will be subject to the Exchanges' sales practice and suitability rules applicable to standardized options. Accordingly, BOUNDS will only be sold to investors whose accounts have been approved for options trading.

#### *Adjustments*

BOUNDS will be subject to adjustments for corporate and other actions in accordance with the rules of OCC. Furthermore, the Options Price Reporting Authority represents that it has the necessary systems capacity to accommodate any new series that would result from the introduction of BOUNDS.<sup>18</sup>

#### *Position Limits*

BOUNDS will be subject to the position limits for equity options.<sup>19</sup> In addition, BOUNDS will be aggregated with other equity options on the same underlying stock for purposes of calculating position limits. Since a BOUND to the holder is a bullish position, the Exchanges propose that long BOUNDS be aggregated with long call and short put positions in the related class of equity options. Similarly, since the Exchanges believe the BOUND, from the perspective of the seller, is a "bearish" position (*i.e.*, it is the equivalent of a long put position where the strike price has been prepaid), they propose to aggregate short BOUNDS with short call and long put positions in the related class of equity options.

The Exchanges propose that positions in BOUNDS shall be reported in accordance with existing options rules, with the minimum position in an account to be reported being 200

<sup>17</sup> A European-style option may only be exercised during a limited period of time before the option expires. An American-style option may be exercised at any time prior to its expiration.

<sup>18</sup> See Memorandums from Joe Corrigan, OPRA, to Michael Walinskas, SEC, dated December 26, 1995 ("Amex OPRA Letter"); Eileen Smith, CBOE, dated January 3, 1996 ("CBOE OPRA Letter"); and Kim Koppien, PSE, dated January 9, 1996 ("PSE OPRA Letter").

<sup>19</sup> See, *e.g.*, Amex Rule 904.

<sup>14</sup> See, *e.g.*, Amex Rule 915.

<sup>15</sup> See Amex and PSE Amendments No. 2 and CBOE Amendment No. 1.

<sup>16</sup> The Amex originally proposed listing BOUNDS with 60 month expirations and extending the maximum duration of LEAPs from 39 months to 60 months. See Amex Amendment No. 1.

BOUNDS on the same underlying security. Finally, due to the lack of trading experience with BOUNDS, Amex and CBOE will not apply their "ten-up" rules, Amex Rule 958A and CBOE Rule 8.51, to BOUNDS transactions.<sup>20</sup>

#### Customer Margin

The Exchanges propose to apply options margin treatment to BOUNDS as follows:

1. Long BOUND Positions: full payment required at the time of purchase.

2. Short BOUND Positions: the BOUND seller receives full payment for the BOUND at the time of the initial sale and receives no further payment when the contract is settled either by payment of the strike price or delivery of the underlying stock. Short BOUND positions, therefore, will be margined in an amount equal to the current market price of the BOUND plus an amount equal to an "add-on" used to margin short call options times the market value of the BOUND. Since the maximum obligation of the seller of a BOUND cannot exceed the strike price, however, the amount of margin will never exceed the strike value. For example:

A. Assume a stock of \$50, an exercise price of \$50, a margin add-on percent of 20% and the BOUND trading at \$40. In this case, the short seller would have to pay \$48 to margin the position, *i.e.*, \$40 BOUND price plus 20% of \$40.

B. Assume a stock price of \$40, an exercise price of \$50, a margin add-on percent of 20% and the BOUND trading at \$35. In this case, the margin would be 42, *i.e.*, \$35 BOUND price plus 20% of \$35.

3. Covered Positions: Short BOUND positions offset by the equivalent number of shares of the underlying stock will not require any additional margin since the seller's obligation to the buyer will, in all cases, be covered by the position in the underlying stock. Further, since it is expected that the sum of the prices of a LEAP and a BOUND will be approximately equal to the price of the underlying stock, a long stock position is cover for both a short BOUND and a short LEAP position, provided the LEAP and BOUND have the same strike price and expiration date.<sup>21</sup>

#### 4. Spread Positions

i. Same Expiration—Different Strike Prices: There will be no margin requirement for BOUND positions

<sup>20</sup> See Amex Amendment No. 2 and CBOE Amendment No. 1.

<sup>21</sup> See Amex and PSE Amendments No. 2.

which are long the higher strike price and short the lower strike price since the long BOUND more than covers the obligation of the short side of the position. For positions short the higher strike price and long the lower strike, a customer will be required to post the difference between the strike prices.

ii. Different Expiration-Same Strike Price: No margin will be required for positions long the nearest expiration and short the longer expiration since the value of the long BOUND will cover the obligation on the short leg of the position.<sup>22</sup> Positions that are short the near expiration and long the distant expiration will require full margin on the short position and payment in full on the long position.<sup>23</sup>

iii. Different Expiration-Different Strike Prices: There will be no margin required for positions that are long the near expiration and short the distant expiration when the strike price on the near expiration is higher than the strike on the distant expiration. For positions which are long the near expiration and short the distant expiration where the strike price on the near expiration is lower than the strike on the distant contract, the margin will be the difference in the strike between the near term and distant strikes. For positions which are short the near expiration and long the distant expiration, full margin will be required on the short position and payment in full on the long position.<sup>24</sup>

#### II. Comments Received

The Commission received comment letters from the New York Stock Exchange ("NYSE Letter") and Motorola, Inc. ("Motorola Letter") in response to its publication and request for comments on the proposals.<sup>25</sup> The NYSE Letter expresses the belief that BOUNDS should be classified an equity product as opposed to a standardized option and that BOUNDS raised significant investor protection concerns.

The NYSE Letter suggests several reasons to categorize BOUNDS as equities and not as options. First, the NYSE argues that BOUNDS do not perform like an option since they do not confer upon the holder a right to buy or sell anything. Second, the NYSE notes that although an option may be either "in" or "out of the money" and may

<sup>22</sup> For positions that are long the nearest expiration, full margin will be required on the short position once the long position expires.

<sup>23</sup> See Amex and PSE Amendments No. 2 and CBOE Amendment No. 1.

<sup>24</sup> See Amex and PSE Amendments No. 2 and CBOE Amendment No. 1.

<sup>25</sup> See *supra* notes 5 and 6 and accompanying text.

expire worthless, BOUNDS are always in the money and cannot expire worthless unless the underlying stock expires worthless. Third, they note that while options are used to transfer risk, BOUNDS do not transfer risk; instead, they believe a BOUND seller only transfers the essential elements of stock ownership, *i.e.*, dividend stream and appreciation up to the cap price to the buyer.

With respect to investor protection concerns, the NYSE Letter noted that Rule 10a-1 under the Act, the "short-sale" rule, would not apply to BOUNDS if they were classified as options and that this could lead to price manipulation of the underlying stock through unregulated short selling of the BOUND. Second, they argue that although position limits would impose an overall limit on the amount of BOUNDS that could be sold by a single trader, there would be no overall limits on the number of LEAPs and BOUNDS that could be sold into the market place, which could cause extreme market volatility. Finally, they argue that while stock specialists have specific affirmative and negative obligations to help ensure orderly markets in the stock, the Commission and the options markets traditionally have not applied such obligations in the options market due to the derivative nature of the instruments and that this creates the potential for market confusion and unequal regulation.

The Motorola letter expresses concern that LEAPs and BOUNDS may allow an investor with no economic interest in a company to maintain voting rights. Specifically, an investor could purchase the underlying stock and then sell both a LEAP and a BOUND. Motorola argues that this division of economic and voting interests is contrary to corporate governance and that significant matters, including corporate control, could be determined by groups of stockholders with absolutely no stake in the outcome. They further state that the "division of economic and voting interests" could create "cheap votes" which could then be sold to the highest bidder.

The Amex submitted a response letter to the Commission, addressing the NYSE's and Motorola's concerns.<sup>26</sup> Amex believes the NYSE and Motorola Letters share an unstated premise that BOUNDS are unique in allowing the creation of a synthetic position in stock. In this regard, Amex notes that investors currently utilize several existing strategies to establish synthetic positions, for example, through the use

<sup>26</sup> See *supra* note 7.

of options and equity linked notes<sup>27</sup> and over-the-counter strategies.

Amex asserts several arguments in response to the NYSE's investor protection/short sale concerns. First, Amex notes that the underlying stock will continue to be subject to the short sale rule and that this would restrain any downward pressure on the price of the underlying stock which might be caused by the BOUNDS. Second, they note that several options strategies (*i.e.*, selling an in the money call, buying a put and selling a call, or buying an in the money put) currently exist for synthetically selling a stock short and that none of these strategies is subject to the Rule 10a-1 tick test nor have such strategies been utilized to manipulate the underlying. Third, Amex believes that the proposed BOUNDS position limit rules will act to limit the number of BOUNDS that may be sold short. Fourth, Amex argues that BOUNDS, by virtue of their options pricing, are an inefficient method of generating selling pressure on the underlying. Fifth, Amex does not believe that the type of price manipulation that rule 10a-1 was intended to prevent can be effected through the derivatives market. Furthermore, Amex believes that ongoing surveillance would adequately address any manipulative activity affected in the derivatives market for the purpose of manipulating the underlying. Finally, Amex argues that the options markets are transparent due to the interposition of OCC, which records all options positions and establishes reporting requirements for options positions of more than 200 equity options contracts. Therefore, Amex believes it would be able to detect suspicious trading activity in BOUNDS promptly.

Amex also responded to Motorola's "cheap vote" concerns by stating that the practical effect of BOUNDS on corporate governance issues would be substantially limited by position limit rules and the requirement that BOUNDS be aggregated with other options positions on the same side of the market. Accordingly, Amex does not believe that BOUNDS will have an effect on proxy contests or tender offers. Furthermore, Amex points out that BOUNDS are inferior to over-the-counter derivatives as a means of affecting shareholder votes since over-the-counter options positions may be tailored by expiration date (*e.g.*, expire the day after

a proxy contest) and price (*e.g.*, establishment of a zero-cost collar).

Finally, the Amex has received a letter from the Commodity Futures Trading Commission ("CFTC") expressing the opinion that BOUNDS are not futures contracts on a single security.<sup>28</sup> In reaching this conclusion, the CFTC noted that given the restrictions on setting strike prices (as discussed above), BOUNDS predominantly exhibit the one-way indexing characteristic of stock options.

### III. Discussion

After careful consideration of the comments received and the applicable statutory provisions, 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, the requirements of Section 6(b)(5). Specifically, the Commission finds that the Exchanges' proposals to list and trade BOUNDS strike a reasonable balance between the Commission's mandates under Section 6(b)(5) to remove impediments to and perfect the mechanism of a free and open market and a national market system, while protecting investors and the public interest. The Commission believes that BOUNDS will provide a new derivative instrument for investors to more closely approximate their desired investment objectives. For the reasons discussed below, the Commission has concluded that the proposals are consistent with the Act.<sup>29</sup>

As an initial matter, the Commission must determine whether it is appropriate for the Exchanges to regulate BOUNDS as standardized options. The Commission is authorized

<sup>28</sup> See Letter from Andrea M. Corcoran and Pat G. Nicolette, Co-Chairpersons, Off-Exchange Task Force, CFTC, to Nathan Most, New Product Development, Amex, dated July 27, 1994. The CFTC letter is based upon the assumption that BOUNDS strike prices will be set at-the-money or out-of-the-money.

<sup>29</sup> Pursuant to Section 6(b)(5) of the Act, the Commission is required to find, among other things, that trading in BOUNDS will serve to protect investors and contribute to the maintenance of fair and orderly markets. In this regard, the Commission must predicate approval of any new derivative product upon a finding that the introduction of the derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument that served no hedging or other economic function, because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. As discussed below, the Commission believes BOUNDS will serve an economic purpose by providing an alternative product that will allow a BOUND holder to forego some of the potential for upside appreciation in return for enhanced income.

pursuant to Rule 9b-1(a)(4) under the Act to include within the definition of standardized options "\* \* \* such other securities as the Commission may, by order, designate." <sup>30</sup> The proposed classification of BOUNDS as standardized options presents certain difficult and unique issues. As discussed above, BOUNDS are intended as a replacement product to the expired PRIMEs. PRIMEs (and SCOREs) were subject to separate unit trust listing standards specifically designed to accommodate their listing and were not treated as standardized options within the meaning of Rule 9b-1. Nevertheless, the Commission believes that BOUNDS, despite possessing some attributes of PRIMEs, can be designated as standardized options for purposes of Rule 9b-1 under the Act.

In this respect, the Commission notes that the value of a particular BOUNDS is derivative of the value of its underlying stock. Moreover, its terms are standardized in the same manner as option contracts, with an underlying security, standardized expiration dates and strike prices. Second, BOUNDS will be subject to options margin treatment. Third, because long BOUNDS positions have the same economic attributes present when a market participant implements a covered call writing strategy, they constitute an aggregation of a synthetic long stock position and short call option position in a single transaction. Accordingly, BOUNDS possess a significant options component. Fourth, while not necessarily determinative of whether a product is an option, BOUNDS, like all other options traded on national securities exchanges, will be issued and cleared by OCC, a registered clearing agency. Fifth, BOUNDS open interest will be created in a manner similar to options. Finally, like a long options position, a long BOUNDS position is created by the deposit of a fully paid for premium, which is the maximum loss on the position.

The Commission recognizes that, as the NYSE letter indicates, BOUNDS differ in several respects from traditional options. Nevertheless, for the reasons stated above, the Commission does not believe it is unreasonable to treat BOUNDS as standardized options.

<sup>30</sup> 17 CFR 240.9b-1(a)(4) (1988). In amending the definition of the term standardized option to include "such other securities as the Commission may, by order, designate" the Commission noted that it added the new language "to authorize the Commission, by order, to allow the use of Rule 9b-1 for new investment vehicles that the Commission believes should be included within the new disclosure framework." See also Securities Exchange Act Release No. 19055 (Sept. 16, 1982), 47 FR 41950, 41954.

<sup>27</sup> Equity linked notes are hybrid instruments whose value is linked to the performance of a highly capitalized, actively traded common stock. See, *e.g.*, Securities Exchange Act Release No. 32343 (May 20, 1993).

Indeed, options treatment may provide a more tailored trading and disclosure regime to the products.<sup>31</sup> Therefore, the Commission has determined the BOUNDS are a type of security that falls into the category of "other security" under Rule 9b-1(a)(4) which the Commission should treat as standardized options for purposes of Rule 9b-1 under the Act.

In treating BOUNDS as options, the Commission must ensure that the Exchanges' proposed regulatory requirements provide for adequate sales practice requirements, position and exercise limits, margin requirements and disclosure. These rules minimize the potential for manipulation and help to address any prudential concerns from a derivative product. In addition, these standards should address the special risks to customers arising from transactions in BOUNDS. For the reasons discussed below, the Commission believes the proposals will provide significant flexibility to list BOUNDS without compromising the effectiveness of the Exchanges' regulatory programs for standardized options.

First, the Exchanges' options sales practice and suitability rules apply to transactions in BOUNDS. The Commission believes it appropriate to apply the heightened requirements of options account opening and suitability rules to BOUNDS transactions because of the significant derivative characteristics of the product. Thus, no member or member organization of any of the Exchanges may accept an order from a customer to purchase, or recommend to any customer any BOUND transaction, unless the account has been approved for options trading and the member or member organization has reasonable grounds to believe that any recommended transaction is not unsuitable for such customer.

Second, the Exchanges propose that equity option position and exercise limit rules be applicable to transactions in BOUNDS and that BOUNDS be aggregated with other equity options on the same underlying stock for the purpose of calculating position limits. The Commission believes that since BOUNDS are standardized options which replicate a covered call writing strategy, it is appropriate to apply equity

options position limits to BOUNDS transactions. The Commission believes it is appropriate to aggregate BOUNDS with equity options (including LEAPs) on the same side of the market on the same underlying stock (*i.e.*, long BOUNDS with long calls and short puts). This will ensure that the protection afforded by options position limits (*e.g.*, prevention of manipulation of the underlying security) will apply to BOUNDS.

As discussed above, the NYSE and Motorola Comment Letters raise short sale and "cheap vote" concerns, respectively. With respect to the "cheap vote" concerns, the Commission agrees with Amex's response and notes that there are several existing strategies whereby an investor can synthetically divest the economic attributes of common stock from actual ownership. As to NYSE's short sale concerns, in light of the fact that BOUNDS will be regulated as standardized options, it is appropriate to grant them the same treatment under Rule 10a-1 of the Act as existing options. Moreover, the Commission notes a BOUNDS' underlying stock will remain subject to Rule 10a-1 at all times. Furthermore, the Commission believes that the proposed position limit and aggregation rules (in addition to margin requirements) should adequately protect against BOUNDS short selling any potential concern over the division of economic and voting interests.

Third, the Exchanges propose that their options margin rules be applicable to transactions in BOUNDS. The initial sale of a BOUND, by definition, will require the seller to go short. In this regard, the Exchanges have submitted proposed rules establishing margin levels for the purchase and sale of BOUNDS, for covered positions (*e.g.*, long stock, short BOUND), and for spread positions involving BOUNDS (*e.g.*, long and short BOUND with same expiration date but different strike prices). The Commission believes that the options-like margin treatment for BOUNDS, as amended, provides for adequate margin coverage for long, short, covered, and spread positions.<sup>32</sup>

The Commission notes that strike price interval, bid/ask differential and continuity rules will not apply to transactions in BOUNDS until the time to expiration is less than nine months. This approach is consistent with the approach currently being taken by the Exchanges with regard to their long-term equity and index options. The

Commission notes that although specific bid/ask differential and continuity rules do not apply to BOUNDS with over nine months to expiration, the Exchanges' general rules that obligate registered options traders, specialists, and market makers to maintain a fair and orderly market will continue to apply.<sup>33</sup> The Commission believes that the requirements of these rules are broad enough, even in the absence of bid/ask differential and continuity requirements, to provide the Exchanges with the authority to make a finding of inadequate registered option trader, specialist, or market maker performance should these market participants enter into transactions or make bids or offers (or fail to do so) in BOUNDS that are inconsistent with the maintenance of a fair and orderly market.

In order to promote investor protection and to ensure adequate disclosure in connection with BOUNDS, the rules pertaining to standardized options and the requirements of Exchange Act Rule 9b-1 will apply to trading in BOUNDS. As with other securities issued by OCC, the clearing corporation interposes itself between BOUND buyers and sellers, and is technically the "issuer" of each contract. Moreover, just as with other OCC issued securities, the Commission believes providing investors with information regarding the rights and characteristics of BOUNDS would provide more useful information to investors than additional information on the issuers underlying the BOUNDS.<sup>34</sup> In this regard, BOUNDS investors will receive a special supplement to the ODD ("BOUNDS supplement") explaining in detail the economic and risk characteristics of BOUNDS, the mechanism of buying, selling and exercising BOUNDS and the market in which BOUNDS will trade.<sup>35</sup> In addition, the Exchanges will require that every exchange member and member organization deliver to each customer a current ODD and BOUNDS supplement at or prior to the time such

<sup>33</sup> See, *e.g.*, Amex Rules 950 and 958 and CBOE Rule 8.7.

<sup>34</sup> The Commission notes that standardized options are registered with the Commission on Form S-20 Registration Statement under the Securities Act of 1933. This information includes the prospectus and financial statements of OCC, which is the issuer of all standardized options.

<sup>35</sup> In reviewing any disclosure materials submitted, the Commission intends to assure that the materials specifically describe BOUNDS, explain their uses, detail the special risks associated with BOUNDS trading, and emphasize that BOUNDS contracts, unlike other standardized options, subject a writer to dividend-equivalent payment obligations. The trading of BOUNDS is expressly contingent upon the Commission's approval of such an ODD supplement.

<sup>31</sup> This determination does not preclude another market from trading a PRIME-like product under stock or hybrid product trading rules. It may be appropriate to use a different regulatory structure than that applicable to BOUNDS for a product that combines equity and derivative features. For BOUNDS, the Commission merely is determining that it is consistent with the Act for the Amex, CBOE, and PSE to apply their options rules and to treat the product as a standardized option.

<sup>32</sup> The Commission staff consulted with staff of the Federal Reserve Board in reaching this determination.

customer's account is approved for BOUNDS trading.

As discussed above, the Exchanges propose to have BOUNDS issued, cleared and settled by OCC. In this regard, on December 27, 1995, OCC filed with the Commission a proposed rule change to enable it to issue, clear, and settle BOUNDS.<sup>36</sup> The OCC proposal, when approved, should allow OCC to process BOUNDS transactions in accordance with procedures that are substantially similar to its existing well-established systems and procedures for the clearance and settlement of exchange-traded options.<sup>37</sup> In this respect, the Commission notes that the initiation of trading of BOUNDS is conditioned upon Commission approval of OCC's proposal to issue, clear and settle BOUNDS, as well as a Commission order approving the BOUNDS ODD supplement.

The Commission finds good cause for approving the Amendments to the proposed rule changes prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register.<sup>38</sup> The Commission notes that the Amendments bring the BOUNDS margin rules applicable to spread positions into conformity with the margin treatment currently applicable to other standardized options. Furthermore, the Amendments also bring the Exchanges' rules into conformity with those of OCC which, the Commission notes, reduces the potential for conflict between an Exchanges' and OCC's rules.<sup>39</sup> Also, the Commission believes it is appropriate for Amex and CBOE to not apply their "ten-up" rules to BOUNDS transactions (*i.e.*, the minimum size guarantee for BOUNDS quotes). In the absence of trading experience or other indication of adequate market liquidity, the Commission believes it is reasonable for the Amex and CBOE to determine that specialists or market makers should not be required to make ten-up markets for transactions in BOUNDS. The Amendments also eliminate the use of escrow receipts and letters of guarantee

as adequate margin cover for BOUNDS. The Commission notes that because it is unknown whether BOUNDS will be settled in cash of the underlying stock until expiration of the BOUNDS position, this raises issues as to whether such instruments serve as adequate cover for short BOUNDS positions. Accordingly, the Commission believes this issue is better addressed in the context of a separate OCC filing. Finally, the Commission notes that PSE's designation of BOUNDS as a Tier I security is consistent with the treatment afforded standardized equity options and, therefore, does not raise any new or unique issues. Accordingly, the Commission believes it is consistent with Sections 6(b)(5) and 19(b)(2) of the Act to approve the Amendment on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the Amendments. 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 Section, 450 Fifth Street, N.W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file numbers in the caption above and should be submitted by February 13, 1996.

Based upon the aforementioned factors, the Commission finds that the proposed rule changes relating to the listing and trading of BOUNDS are consistent with the requirements of Section 6(b)(5) and the rules and regulations thereunder. The initiation of BOUNDS trading, however, is conditioned upon the issuance of an order approving the OCC's proposed rule change to issue, clear, and settle BOUNDS and also upon the Commission's review and approval of an ODD BOUNDS supplement, pursuant to Rule 9b-1 of the Act.

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,<sup>40</sup> that the proposed rule changes (SR-Amex-94-56, SR-CBOE-05-14, and SR-PSE-95-01) are approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>41</sup>

Margaret H. McFarland,

*Deputy Secretary.*

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### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the American Stock Exchange, Inc. Relating to Options on the Morgan Stanley Healthcare Product Companies Index, the Morgan Stanley Healthcare Providers Index and the Morgan Stanley Healthcare Payors Index

January 16, 1996.

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 December 19, 1995, the American Stock Exchange, Inc. ("Amex" 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 Amex. On January 2, 1996, the Amex filed Amendment No. 1 to its proposal.<sup>1</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to approve for listing and trading options on three new indexes developed by Morgan Stanley & Co. Incorporated ("Morgan Stanley") relating to three different subsectors within the healthcare sector: the Morgan Stanley Healthcare Providers Index ("Providers Index"); the Morgan Stanley

<sup>40</sup> 15 U.S.C. § 78s(b)(2) (1988).

<sup>41</sup> 17 CFR 200.30-3(a)(12) (1994).

<sup>1</sup> In Amendment No. 1, the Amex states that for each of the healthcare sector indexes, if at any time between annual rebalancings, the top five stocks in an Index by weight represent in the aggregate more than 60% of the Index's value, the Exchange will rebalance the Index after the close of trading on Expiration Friday in the next month in the March cycle. See Letter from Claire P. McGrath, Managing Director and Special Counsel, Derivatives Securities, Amex, to Michael Walinskas, Branch Chief, Office of Market Supervision, Division of Market Regulation, Commission, dated January 2, 1996 ("Amendment No. 1").

<sup>36</sup> See SR-OCC-95-20.

<sup>37</sup> The Commission has not yet approved OCC's proposed rule filing to issue, clear, and settle BOUNDS (SR-OCC-95-20).

<sup>38</sup> Amex Amendment No. 1 was noticed and published for comment with the original filing. The Commission, therefore, is not seeking comment on Amex Amendment No. 1.

<sup>39</sup> For example, one of the changes alters the timing of the payment of the BOUNDS dividends equivalent. The Commission notes that this change, which brings the Exchanges' rules into conformity with the rules of OCC, will harmonize the payment date for BOUNDS with that of the underlying stock, and that this should make trading strategies involving both the BOUNDS and underlying stock more efficient.