

Also, participants may view the status of their trades (*i.e.*, unaffirmed, affirmed, or cancelled).

The third feature of the proposed rule change allows participants to use Philanet to verify the receipt of their transmissions by Philadep and the total number of the respective trades associated with each transmission.

Philadep believes its proposed rule change is consistent with the requirements of Section 17A the Act because it fosters cooperation and coordination with person engaged in the clearance and settlement of securities transactions and further assures the safeguarding of securities which are in the custody and control of Philadep.

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

Philadep does not believe that the proposed rule change will have an impact on or impose a burden on competition.

(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 with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(iii)⁴ of the Act and pursuant to Rule 19b-4(e)(4)⁵ promulgated thereunder because the proposal effects a change in an existing service of Philadep that does not adversely affect the safeguarding of securities or funds in the custody or control of Philadep and does not significantly affect the respective rights or obligations of Philadep or persons using the service. At any time within sixty days of the filing of such rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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, NW, 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 provision of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of Philadep. All submissions should refer to File Number SR-Philadep-95-13 and should be submitted by April 1, 1996.

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

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-36935; File No. SR-Phlx-95-92]

Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc., Relating to the Listing and Trading of Options on the Phlx OTC Industries Average Index

March 6, 1996.

I. Introduction

On December 21, 1995, the Philadelphia Stock Exchange, Inc., ("Phlx" or "Exchange") filed a proposed rule change with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and rule 19b-4 thereunder,² to provide for the listing and trading of index options on the Phlx OTC Industrial Average Index ("OTC Industrial Index" or "Index"). The Exchange filed with the Commission Amendment No. 1 to the proposal on December 27, 1995.³ The Exchange filed

⁶ 17 CFR § 200.30-3(a)(12) (1994).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange amended the proposed rule change to indicate that the Index will be treated as a narrow based index. See Letter from Nandita Yagnik, New Product Development, Phlx, to John

with the Commission Amendment No. 2 to the proposal on February 28, 1996.⁴

Notice of the proposal, as amended, was published for comment and appeared in the Federal Register on January 26, 1996.⁵ No comment letters were received on the proposed rule change. This order approves the Exchange's proposal, as amended.

II Description of the Proposal

A. General

The Exchange proposes to list and trade options on the Phlx OTC Industrial Average Index, a price-weighted⁶ index developed by the Phlx based on some of the largest stocks, by capitalization, traded through the National Association of Securities Dealers Automated Quotations system and are reported national market system securities ("NASDAQ/NMS").

B. Composition of the Index

The Index was designed by the Exchange and is currently composed of ten of the most highly capitalized and widely held common stocks of U.S. companies. The Index is composed entirely of NASDAQ/NMS securities. Currently, the Index represents diversified industries including Telecommunications, Pharmaceuticals, Semiconductors, and Data Processing.⁷ All component stocks are "reported securities," as that term is defined in Rule 11a3-1 of the Act.⁸ The Index is price-weighted and will be calculated on a real-time basis using last sale prices.

As of the close of trading on January 4, 1996, the Index was valued at 279.27. As of November 9, 1995, the market capitalizations of the individual securities in the Index ranged from a high of \$57.5 billion to a low of \$8.2

Ayanian, Attorney, Office of Market Supervision ("OMS"), Division of Market Regulation ("Market Regulation"), Commission, dated December 27, 1995 ("Amendment No. 1").

⁴ The Exchange proposed additional maintenance standards to the Index, as described more fully herein. See Letter from Nandita Yagnik, New Products Development, Phlx, to John Ayanian, Attorney, OMS, Market Regulation, Commission, dated February 28, 1996 ("Amendment No. 2").

⁵ See Securities Exchange Act Release No. 36744 (January 19, 1996), 61 FR 2562.

⁶ See *infra* Section II.E, entitled "Calculation of the Index," for a description of this calculation methodology.

⁷ The component's of the Index are: Amgen, Inc.; Applied Materials; Bay Networks, Inc.; CISCO Systems; Intel Corp.; Microsoft Corp.; MCI Communications; Oracle Corp.; Sun Microsystems; and Tele Communications, Inc.

⁸ See 17 CFR 240.11Aa3-1. A "reported security" is defined in paragraph (a)(4) of this rule as "any listed equity security or NASDAQ security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan."

⁴ 15 U.S.C. § 78s(b)(3)(A)(iii) (1988).

⁵ 17 CFR § 240.19b-4(e)(4) (1995).

billion, with the mean being \$22.4 billion. The market capitalization of all the securities in the Index was \$224.5 billion. The total number of shares outstanding on that date for the stocks in the Index ranged from a high of 821.2 million shares to a low of 90.9 million shares.⁹ Also on that date, the price per share in the U.S. of the securities in the Index ranged from a high of \$85.375 to a low of \$18.250. The average daily trading volume for the six month period from August 1, 1995 to February 1, 1996 ranged from a high of 18.7 million shares to a low of 1.29 million shares.¹⁰ The average daily trading volume for all of the components of the Index for the same period was approximately 63.4 million shares.¹¹ Lastly, no one component accounted for more than 15.59% of the Index's total value and the percentage weighting of the five largest issues in the Index accounted for 67.35% of the Index's value. The percentage weighting of the lowest weighted component was 3.31% of the Index.

C. Maintenance

The Phlx has retained Bridge Data, Inc. to compute and do all necessary maintenance of the Index. The Index value will be updated dynamically at least once every 15 seconds during the trading day. Pursuant to Phlx rule 1100A, updated Index values will be disseminated and displayed by means of primary market prints reported by the Consolidated Tape Association and over the facilities of the Options Price Reporting Authority. The Index value will also be available on broker/dealer interrogation devices to subscribers of the option information.

In accordance with Phlx rule 1009A, if any change in the nature of any stock

in the Index occurs as a result of delisting, merger, acquisition or otherwise, the Exchange will take appropriate steps to delete that stock from the Index and replace it with another stock which the Exchange believes would be compatible with the intended market character of the Index. In making replacement determinations, the Exchange will also take into account the capitalization, liquidity, and volatility of a particular stock.

The Exchange represents that component stocks constituting the top 90% of the Index by weight, must have a minimum market capitalization of \$75 million and the component stocks constituting the bottom 10% of the Index, by weight, must have a minimum market capitalization of \$50 million. Additionally, the Phlx provides that the Index must meet the criteria that no single component represents more than 25% of the weight of the Index and that the five highest weighted components represent no more than 75% of the Index as of the first day of January and July in each year. Moreover, the Phlx represents that the monthly trading volume of each component security shall be at least 500,000 shares, or for each of the lowest weighted components in the Index that in the aggregate account for no more than 10% of the weight of the Index, the monthly trading volume must be at least 400,000 shares.¹² Finally, the Exchange represents that all of the stocks comprising the Index are options eligible¹³ and have overlying options currently trading. At least 90% of the component issues, by weight, and 80% of the number of stocks, must be options eligible at all times.¹⁴ If at any time the Index does not meet any of these maintenance requirements, the

Exchange will submit a Rule 19b-4 filing to the Commission before opening any new series of options on the Index for trading. Additionally, if at any time, the Exchange determines to increase to more than thirteen or decrease to fewer than seven, the number of component issues in the Index, the Exchange will submit a new Rule 19b-4 filing. Options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 7,000,000 shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume in the U.S. must have been at least 2.4 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$7.50 for a majority of the business days during the preceding three calendar months. See Phlx Rule 1009, Commentary .01.

D. Applicability of Phlx Rules Regarding Index Options

Except as modified by this order, Phlx Rules 1000A through 1103A, in particular, and Phlx Rules 1000 through 1070, in general, will be applicable to OTC Industrial Index options. Those rules address, among other things, the applicable position and exercise limits, policies regarding trading halts and suspensions, and margin treatment for narrow-based index options.

E. Calculation of the Index

The Phlx OTC Industrial Index is a price-weighted index and reflects changes in the prices of the Index component securities relative to the Index's base date of November 1, 1995. The formula for calculating the OTC Industrial Index is as follows:

$$\text{Index Value} = \frac{SP_1 + SP_2 + SP_3 + \dots + SP_{13}}{\text{divisor}} \times 100$$

SP=the stock price of each component.

The current price of each component issue is added and multiplied by 100 shares to determine the current

⁹ See Letter from Nandita Yagnik, New Products Development, Phlx, to John Ayanian, Attorney, OMS, Market Regulation, Commission, dated February 23, 1996 ("Trading Data Letter").

¹⁰ *Id.*

¹¹ *Id.*

¹² See Amendment No. 2, *supra* note 4.

¹³ The Phlx's options listing standards, which are uniform among the

¹⁴ Telephone conversation between Michele Weisbaum, Associate General Counsel, Phlx, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on January 18, 1996.

aggregate market value of the issues in the Index. To compute the current Index value, the aggregate market value is divided by the divisor. The Index value was set at a starting value of 150 as of November 1, 1995.

In order to maintain continuity in the value of the Index, the Index divisor will be adjusted for changes in capitalization of any of the component issues resulting from, among other things, mergers, acquisitions, delistings, and substitutions. Adjustments in the value of the Index which are necessitated by the addition and/or the deletion of an issue from the Index are

made by adding and/or subtracting the market value (price times shares outstanding) of the relevant issues. The value of the Index as of the close of trading on Friday, January 4, 1996 was 279.27.

The settlement value for the Index options will be based on the opening values of the component securities on the date prior to expiration. Index options will expire on the Saturday following the third Friday of the expiration month, and the last day for trading in an expiring series will be the second business day (ordinarily a Thursday) preceding the expiration

date. If any of the component stocks do not open for trading on the last trading day before expiration, then the prior trading day's (i.e., normally Thursday's) last sale price will be used in the Index calculation.

F. Contract Specifications

The proposed Index options will be cash-settled, European-style options. As with the Exchange's other indexes, the multiplier for options on the OTC Industrial Index will be 100. The OTC Industrial Index options will trade from 9:30 a.m. to 4:10 p.m. eastern time. Exercise prices will be initially set at 5 point intervals and additional exercise prices will be added in accordance with Phlx Rule 1101A(a).

The Phlx will trade consecutive and cycle month series pursuant to Phlx Rule 1101A. Specifically, there will be three expiration months from the March, June, September, December cycle plus two additional near-term months so that the three nearest term months will always be available.

G. Position and Exercise Limits, Margin Requirements, and Trading Halts

Because the Index is classified as an "industry index" under Phlx rules, Exchange rules that are applicable to the trading of options on narrow-based indexes will apply to the trading of OTC Industrial Index options. Specifically, Exchange rules governing position and exercise limits,¹⁵ margin requirements,¹⁶ and trading halt procedures¹⁷ that are applicable to the trading of the Exchange's other industry index options will apply to options traded on the Index.

H. Surveillance

The Exchange notes that procedures currently used to monitor trading in each of the Exchange's other index options will also be used to monitor the trading of options on the OTC Industrial Index. These procedures included having complete access to trading

¹⁵ Pursuant to Phlx Rules 1001A and 1002A, respectively, the position and exercise limits for the Index options will be 9,000 contracts. See Amendment No. 1, *supra* note 3.

¹⁶ Pursuant to Phlx Rule 722, the margin requirements for the Index options will be: (1) for short options positions, 100% of the current market value of the options contract plus 20% of the underlying aggregate Index value, less any out-of-the-money amount, with a minimum requirement of the options premium plus 10% of the underlying Index value; and (2) for long options positions, 100% of the options premium paid. See Amendment No. 1, *supra* note 3.

¹⁷ Pursuant to Phlx Rule 1047A, the trading on the Phlx of Index options may be halted or suspended whenever trading in the underlying securities whose weighted value represents more than 10% of the Index value are halted or suspended.

activity in the underlying securities which are all traded through NASDAQ via the Intermarket Surveillance Group Agreement ("ISG Agreement") dated July 14, 1983, as amended on January 29, 1990.¹⁸

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act in general and furthers the objectives of Sections 6(b)(5) in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of change, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market systems.

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).¹⁹ Specifically, the Commission finds that the trading of OTC Industrial Index options will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with a means of hedging exposure to market risk associated with heavily traded industrial securities traded through NASDAQ.²⁰ The trading of

¹⁸ The Intermarket Surveillance Group ("ISG") was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. See Intermarket Surveillance Group Agreement, July 14, 1983. The most recent amendment to the ISG Agreement, which incorporates the original agreement and all amendments made thereafter, was signed by ISG members on January 29, 1990. See Second Amendment to the Intermarket Surveillance Group Agreement, January 29, 1990. The members of the ISG are: the Amex; the Boston Stock Exchange, Inc.; the CBOE; the Chicago Stock Exchange, Inc.; the National Association of Securities Dealers, Inc. ("NASD"); the NYSE; the Pacific Stock Exchange, Inc.; and the Philadelphia Stock Exchange, Inc. Because of potential opportunities for trading abuses involving stock index futures, stock options, and the underlying stock and the need for greater sharing of surveillance information for these potential intermarket trading abuses, the major stock index futures exchanges (e.g., the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

¹⁹ 15 U.S.C. 78f(b)(5).

²⁰ Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option proposal upon a finding that the introduction of such new 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

options on the OTC Industrial Index, however, raises several issues related to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the Phlx has adequately addressed these issues.

A. Index Design and Structure

The Commission finds that the OTC Industrial Index is a narrow-based index, because it is only composed of ten stocks, comprising some of the largest industrial securities traded through NASDAQ. Accordingly, the Commission believes it is appropriate for the Phlx to apply its rules governing narrow-based index options to trading in the Index options.²¹

The Commission also finds that the large capitalizations, liquid markets, and relative weightings of the individual securities comprising the Index minimize the potential for manipulation of the Index. First, the securities comprising the Index are actively traded, with an average daily trading volume for all components for the period from August 1, 1995 through February 1, 1996, of approximately 63.4 million shares per day. Second, as of November 9, 1995, the market capitalizations of the individual securities in the Index ranged from a high of \$57.5 billion to a low of \$8.2 billion, with the mean being \$22.4 billion. Third, although the Index is composed of only 10 securities, no particular component security or group of securities dominates the Index. Specifically, as of November 16, 1995, no component security contained in the Index accounted for more than 15.59% of the Index's total value and the five highest weighted securities in the Index accounted for 67.35% of the Index's value.

Fourth, the proposed maintenance criteria will serve to ensure that: (1) The Index remains composed substantially of liquid, highly capitalized securities; and (2) the Index is not dominated by any one security that does not satisfy the Exchange's options listing criteria. Specifically, in considering changes to the composition of the Index, 90% of the weight of the Index and 80% of the number of components in the Index must comply with the listing criteria for standardized options trading set forth in

participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed Index options will provide investors with a hedging vehicle that should reflect the overall movement of some of the most heavily traded industrial securities traded through NASDAQ.

²¹ See *supra* Section II.G.

Phlx Rule 1009 (for securities that are not then the subject of standardized options trading) and Phlx Rule 1010 (for securities that are then the subject of standardized options trading).²² Additionally, the Phlx is required to review the composition of the Index at least quarterly to ensure that the Index continues to meet this 90%/80% criterion.

The Phlx will promptly notify the Commission staff at any time that the Phlx determines that the Index fails to satisfy any of the above maintenance criteria. Further, in such an event, the Exchange will not open for trading any additional series of Index options unless the Exchange determines that such failure is not significant, and the Commission staff affirmatively concurs in that determination, or unless the Commission specifically approves the continued listing of that class of Index options pursuant to a proposal filed in accordance with Section 19(b) of the Act.

For the above reasons, the Commission believes that these criteria minimize the potential for manipulation of the Index and eliminate domination concerns.

B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as OTC Industrial Index options, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) the special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index options will be subject to the same regulatory regime as the other standardized index options currently traded on the Phlx, the Commission believes that adequate safeguards are in place to ensure the protection of investors in OTC Industrial Index options.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the

²² Additionally, the securities contained in the Index must be "reported" securities and must be Nasdaq/NM securities.

exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation.²³ In this regard, the Commission notes that the NASD, the self-regulatory organization which oversees NASDAQ, the primary market for all of the Index's component securities, is a member of the ISG.²⁴ The Commission believes that this arrangement ensures the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the Index option less readily susceptible to manipulation.

D. Market Impact

The Commission believes that the listing and trading on the Phlx of OTC Industrial Index options will not adversely impact the markets for the securities contained in the Index.²⁵ First, as described above, no one security or group of securities represented in the Index currently dominates the Index and the maintenance standards will continue to ensure that such domination does not occur. Second, the maintenance criteria for the Index ensure that the Index will be substantially comprised of securities that satisfy the Exchange's listing standards for standardized options trading and that the component stocks are actively-traded and well capitalized. Third, the 9,000 contract position and exercise limits applicable to Index options will serve to minimize potential manipulation and market impact concerns.

Lastly, the Commission believes that settling expiring OTC Industrial Index options based on the opening prices of the component securities is consistent with the Act.

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

²³ See Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992).

²⁴ See *supra* note 16.

²⁵ The Commission notes that trading of Phlx OTC Industrial Average Index options is contingent upon the Exchange submitting to the Commission's Division of Market Regulation, the letter from OPRA ("OPRA Capacity Letter") to the Exchange indicating that the Exchange has adequate systems processing capacity to accommodate the listing of OTC Industrial Index options.

Specifically, Amendment No. 2 provides objective maintenance criteria which, for the reasons stated above, minimize the potential for manipulation of the Index and the securities comprising the Index. Further, as discussed above, the Commission believes that these maintenance criteria significantly strengthen the customer protection and surveillance aspects of the proposal, as originally proposed.

Based on the above, the Commission finds good cause for approving Amendment No. 2 to the proposed rule change on an accelerated basis and believes that the proposal, as amended, is consistent with Sections 6(b)(5) and 19(b)(2) of the Act.

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 at 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 Phlx. All submissions should refer to the File Number SR-Phlx-95-92 and should be submitted by April 1, 1996.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁶ that the proposed rule change (File No. SR-Phlx-95-92), as amended, is approved.²⁷

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁸

Margaret H. McFarland,

Deputy Secretary.

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²⁶ 15 U.S.C. 78s(b)(2).

²⁷ As noted above, trading of OTC Industrial Index options is contingent upon the Exchange submitting the OPRA Capacity Letter to the Division of Market Regulation. See *supra* note 25.

²⁸ 17 CFR 200.30-3(a)(12).