

[Release No. 34-38081; File No. SR-PSE-96-40]

**Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change by the Pacific Stock Exchange, Inc., Relating to the Listing and Trading of Index Options on the Dow Jones & Co. Taiwan Index**

December 23, 1996.

**I. Introduction**

On October 17, 1996, the Pacific Stock Exchange, Inc. ("PSE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to list and trade index options based on the Dow Jones & Co. ("Dow Jones & Co.") Taiwan Index ("Index").

The proposed rule change appeared in the Federal Register on October 25, 1996.<sup>3</sup> No comments were received on the proposed rule change. The Exchange subsequently filed Amendment No. 1 to the proposed rule change on December 17, 1996.<sup>4</sup> This order approves the PSE's proposal, as amended.

**II. Description**

The Exchange is proposing to list and trade cash-settled, European-style<sup>5</sup> stock index options on the Dow Jones & Co. Taiwan Index. The Index is comprised of 113 representative stocks traded on the Taiwan Stock Exchange ("TSE").<sup>6</sup> According to the Exchange, the Index is representative of the Taiwan stock market as a whole, and therefore, is deemed a broad-based index.

**A. Index Design**

The Index was designed, and is maintained, by Dow Jones & Co. The 113 stocks comprising the Index were selected for their market weight, trading liquidity, and their representation of the

business industries reflected on the TSE. The Exchange believes that these stocks reflect the industrial composition of the broader Taiwanese equity market. Specifically, stocks from nineteen different economic sectors of the Taiwan stock market were ranked by their market value and the largest stocks were selected from the sectors until approximately 80% of the market was represented by Index stocks.<sup>7</sup>

Only publicly traded and liquid common stocks are considered for inclusion in the Index. Stocks which are not traded frequently, do not have sufficiently high share turnover, or a sufficiently large dollar volume are excluded from the Index. Companies whose stocks are 75% owned by another company or state entity will be excluded, and companies controlled by a family or an individual are carefully reviewed before inclusion.

The Index is weighted by the market capitalization of the component stocks. As of August 30, 1996, the market capitalization of the Index was US\$181 billion<sup>8</sup> (at the exchange rate of NT \$27.5 per dollar), which represents approximately 80% of the capitalization of the TSE. The average market capitalization of these stocks was US\$1.6 billion on the same date (at the same rate of exchange). The individual market capitalization of these stocks ranged from US\$18.6 billion (Cathay Life Insurance) to US\$150 million (Hong Ho Precision Textile Co.) on the same date. The largest stock accounted for 10.26% of the Index, while the smallest accounted for .08%. The top five stocks in the Index, by weight, accounted for approximately 31% of the Index.<sup>9</sup> The average daily trading volume of the component securities for the period April 1 through August 30, 1996, ranged from a high of 49,879,418 shares (China Steel) to a low of 457,091 shares (Hsing Ta Cement Co.), with an average daily trading volume for all components of the Index of approximately 7,698,763 shares. For the quarter ended September 30, 1996, the Index components, in the

aggregate, had an average daily trading volume of US\$1.1 billion.

**B. Calculation and Maintenance of Index**

The value of the Index is determined by multiplying the price of each stock by its number of shares included in the Index, adding those sums, and then dividing by a divisor which gives the Index value of 100 on its base date of December 31, 1991. The Index had a closing value of 160.33 on August 30, 1996. The Index will be maintained by Dow Jones & Co. and, in order to maintain continuity of the Index, the divisor of the Index will be adjusted to reflect certain events relating to the component stocks. These events include, but are not limited to, changes in the number of shares outstanding, spin-offs, certain rights insurances, and mergers and acquisitions.

The composition of the Index is reviewed every quarter using size, liquidity, and investibility screens. Dow Jones & Co. may make component changes at any time to ensure that the Index continues to represent the overall character of the Taiwanese equity market. To restrict turnover at quarterly revisions, however, an Index stock can be replaced by a new stock from the same economic sector only if the market value of the new stock exceeds its market value by a threshold amount. Index stocks may also be replaced when necessary between quarterly reviews following special corporate events such as delistings, mergers, or acquisitions. Adjustments may also become necessary following changes in government restrictions on the foreign ownership of stocks.

In addition, in the event that the Index does not comply with any of the following maintenance criteria, the Exchange will notify the Commission to determine the appropriate regulatory response: (a) the number of component stocks in the Index changes and there are more than 150 stocks or less than 75 stocks comprising the Index; (b) at the time of a quarterly review, a component's market capitalization is below \$75 million; (c) the top weighted component stock accounts for more than 25% of the weight of the Index; or (d) the top three weighted stocks account for more than 45% of the weight of the Index.<sup>10</sup> The Commission's and the PSE's regulatory responses for failure to meet the above criteria could include, but are not limited to, the removal of the securities from the Index, prohibiting opening transactions, or discontinuing

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988).

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

<sup>3</sup> See Securities Exchange Act Release No. 37842 (October 18, 1996), 61 FR 55345 (October 25, 1996).

<sup>4</sup> See letter from Michael D. Pierson, Senior Attorney, Regulatory Policy, PSE, to Matthew Morris, Office of Market Supervision, Division of Market Regulation, Commission, dated December 17, 1996 ("Amendment No. 1"). In No. 1, the PSE amended its rule filing regarding its maintenance criteria and Index value dissemination procedures. See *infra* notes 10 and 12, and accompanying text.

<sup>5</sup> European-style options may only be exercised during a specified period before expiration.

<sup>6</sup> A list of Index components is available at the Commission and at the PSE.

<sup>7</sup> Due to foreign investment restrictions of Taiwanese stocks, Dow Jones & Co. only includes 20% of a component stocks' total shares outstanding in calculating the market capitalization. Accordingly, only 20% of the actual market value of the component stocks is represented by the Index.

<sup>8</sup> This figure includes all outstanding shares for each component stock. The Index itself is comprised of approximately 20% of this figure, of US\$36.2 billion. See *supra* note 7.

<sup>9</sup> The five most heavily weighted stocks in the Index as of August 30, 1996 were: Cathay Life Insurance (10.26%); First Commercial Bank (5.98%); Hua Nan Bank (5.75%); Chang Hwa Bank (5.22%); and China Steel (3.88%).

<sup>10</sup> See Amendment No. 1.

the listing of new series of Index options.

### C. Index Option Trading

The Exchange proposes to base trading in options on the Index on the full value of the Index as expressed in U.S. dollars. The Exchange also may provide for the listing of long-term index option series ("LEAPS") on the Index. The Exchange will list expiration months for Index options and Index LEAPS in accordance with PSE Rule 7.8.

The trading hours for options on the Index will be from 6:30 a.m. Pacific time to 1:15 p.m. Pacific time.<sup>11</sup> With no overlap in trading hours between the PSE and the TSE, the Exchange is proposing to disseminate the Index value only at the beginning of each trading day.<sup>12</sup> Specifically, the PSE plans to disseminate the Index value via the Consolidated Tape Authority ("CTA") Network B once a day at the opening of trading. The Index value will be subsequently re-disseminated throughout the trading day through data vendors as well as through the Dow Jones Global Index web site.

In addition, the Exchange will be trading options on an Index value that is calculated in the "local currency" (i.e., Taiwan dollars) and not converted into U.S. dollars. Although premiums will be in U.S. dollars, the strike prices will be based on the local currency Index level. It also should be noted that the futures and futures options that will be traded at the Chicago Mercantile Exchange ("CME") will be based on the same underlying Index and the same Index value.

The Exchange is proposing to establish position limits for Index options equal to 50,000 contracts on the same side of the market, with no more than 30,000 contracts in the series with the nearest expiration date. According to the Exchange, these limits are roughly equivalent, in dollar terms, to the limits applicable to options on other indices. Furthermore, the hedge exemption rule applicable to broad-based index options will apply to Index options.<sup>13</sup>

The PSE also represents that it has the necessary systems capacity to support

<sup>11</sup> Regular trading hours in Taiwan are Monday to Friday 0900-1200, and Saturday from 0900-1100.

<sup>12</sup> According to the PSE, the Consolidated Tape Authority ("CTA") has asked the options exchanges to evaluate the need to disseminate index values based on foreign indices every fifteen seconds when the index value does not change during U.S. trading hours. The CTA is concerned that disseminating the same index value every fifteen seconds results in unnecessary data traffic. By disseminating the Index value only once a day, the Exchange believes that it is complying with the CTA's request. See Amendment No. 1.

<sup>13</sup> See Commentary .02 to PSE Rule 7.6.

new series that would result from the introduction of the Index options.

### D. Exercise and Settlement

The proposed options on the Index will expire on the Saturday following the third Friday of the expiration month, and trading in the expiring contract month on the PSE will normally cease on Friday at 1:15 p.m. Pacific time unless a holiday occurs. The exercise settlement value of Index options at expiration will be determined from closing prices established at the close of the regular Friday trading session in Taiwan. If a stock does not trade during this interval or if it fails to open for trading, the last available price of the stock will be used in the calculation of the Index. When expirations are removed in accordance with Exchange holidays, such as when the PSE is closed on the Friday before expiration, the last trading day for expiring options will be Thursday and the exercise settlement value of Index options at expiration will be determined at the close of the regular Thursday trading sessions in Taiwan even if the Taiwanese markets are open on Friday. If the Taiwanese markets are closed on the Friday before expiration but the PSE is open for trading, the last trading day for expiring options will similarly be Thursday, with the exercise settlement value being determined from Thursday closing prices on the TSE.

### E. Surveillance

The Exchange will apply its existing index option surveillance procedures to Index options. In addition, the Exchange has entered into a surveillance sharing agreement with the TSE, which should, as discussed below, enable the Exchange to obtain information concerning the trading of the component stocks of the Index.

### III. 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, with the requirements of Section 6(b).<sup>14</sup> Specifically, the Commission finds that the trading of index options based on the Dow Jones & Co. Taiwan Index, including long-term index options, will serve to protect investors, promote the public interest, and will help to remove impediments to a free and open market by providing investors with a means to hedge exposure to the market risk associated with the Taiwanese equity

<sup>14</sup> 15 U.S.C. 78f(b) (1988).

market and to provide a risk management instrument for positions in the Taiwanese securities market.<sup>15</sup>

Nevertheless, the trading of options on the Index raises several issues related to the design and structure of the Index, customer protection, and surveillance. The Commission believes, however, for the reasons discussed below, that the PSE has adequately addressed these issues.

### A. Index Design and Structure

The Commission finds that it is appropriate and consistent with the Act to apply the Exchange rules applicable to broad-based index options to the Index options. First, the Index consists of 113 of the most actively traded stocks on the TSE. Second, stocks in the Index are among the most highly capitalized stocks on the TSE. For example, on August 30, 1996, the market capitalization of the Index was US\$181 billion (at the exchange rate of NT \$27.5 per dollar), which represents approximately 80% of the capitalization of the TSE. In addition, the market capitalization of the individual stocks in the Index ranged from a high of US\$18.6 billion (Cathay Life Insurance) to a low of US\$150 million (Hong Ho Precision Textile Co.), with an average market capitalization of US\$1.6 billion. Third, the Index includes stocks of companies from nineteen separate industries. Fourth, PSE maintenance criteria require that no single Index component shall comprise more than 25% of the Index's total value, and that the percentage weighting of the three largest issues in the Index shall not exceed 45% of the Index's value. This will help to ensure that a single stock or small group of stocks does not dominate the Index.<sup>16</sup> Fifth, Dow Jones & Co. has adopted listing and maintenance criteria to ensure that the Index maintains its broad representative sample of stocks as well as a variety of industries and economic sectors.<sup>17</sup> In addition, the

<sup>15</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new securities product upon a finding that the introduction of such product is in the public interest. Such a finding would be difficult with respect to a product 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.

<sup>16</sup> As noted above, as of August 30, 1996, the top five stocks in the Index, by weight, accounted for approximately 31% of the Index, and no single stock accounted for more than 10.26% of the Index. See *supra* note 9 and accompanying text.

<sup>17</sup> For example, the Exchange's maintenance criteria require that at the time of a quarterly review, a component's market capitalization be

maintenance criteria will ensure that the Index continues to be comprised of component stocks that are among the most highly capitalized and actively traded stocks on the TSE. Accordingly, the Commission believes it is appropriate to classify the Index as broad-based.

For many of the same reasons, the Commission believes that the general broad diversification of the Index component stocks, as well as their high capitalizations and trading activity, lessen the potential for manipulation of the index. First, as noted above, the Index represents a broad cross-section of highly-capitalized Taiwanese stocks, with no single industry group or stock dominating the Index. Second, the stocks that comprise the Index are relatively actively traded. Third, the Commission believes that the Index selection and maintenance criteria will serve to ensure that the Index continues to represent stocks with the highest capitalizations and trading volumes on the TSE. In addition, the Exchange has proposed position and exercise limits for the Index options that are consistent with other broad-based index options. Finally, as discussed in more detail below, the Commission believes that adequate surveillance mechanisms exist between the PSE and the underlying security market to detect and deter potential market manipulation and other trading abuses.

#### 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 the Dow Jones & Co. Taiwan Index options and Index LEAPS, 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 and Index LEAPS will

above \$75 million, and that the number of component stocks in the Index not be more than 150 or less than 75 stocks. In the event that the Index does not comply with any of the Exchange's maintenance criteria, the PSE will notify the Commission to determine that appropriate regulatory responses. Such responses could include, but are not limited to, the removal of the securities from the Index, prohibiting opening transaction, or discontinuing the listing of new series of Index options.

be subject to the same regulatory regime as the other standardized options currently traded on the PSE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in Dow Jones & Co. Taiwan Index options and Index LEAPS.

#### C. Surveillance

In evaluating a proposal to trade a new derivative instrument, the Commission, consistent with the protection of investors, considers the degree to which the derivative market can conduct adequate surveillance of trading in the instrument. The ability of the options market to obtain information necessary to detect and deter market manipulation and other trading abuses is a critical factor in this evaluation. It is for this reason that it is important that the Commission determine that there is an adequate mechanism in place to provide for the exchange of information between the market trading the derivative product and the market on which the securities underlying the derivative product are traded. Such mechanisms enable officials to surveil trading in both the derivative product and the underlying securities.<sup>18</sup> For foreign stock index derivative products, such mechanisms are especially important for the relevant foreign and domestic exchanges to facilitate the collection of necessary regulatory, surveillance, and other information.

The Commission notes that the PSE and the TSE have entered into a Memorandum of Understanding ("MOU") which appears to enable the Exchange to obtain necessary surveillance information concerning the trading of the component stocks of the Index, including the identity of persons who execute transactions on either the TSE or the PSE.<sup>19</sup> The Commission recognizes, however, that there are conditions that affect the flow of information under the MOU between

<sup>18</sup>The Commission believes that a comprehensive surveillance sharing agreement should provide the parties with the ability to obtain information necessary to detect and deter market manipulation and other trading abuses. Consequently, the Commission generally insists that such agreements require that the parties provide each other, upon request, with information about market trading activity, clearing activity, and the identity of the purchasers and sellers of securities underlying the derivative product. See, e.g., Securities Exchange Act Release No. 31529 (November 27, 1992), 57 FR 574248 (December 3, 1992) (File No. Amex-91-26) (order approving proposed rule changes relating to the listing and trading of options on American Depositary Receipts and preferred stock).

<sup>19</sup>See Memorandum of Understanding Concerning the Provision of Information for the Purpose of Regulation and Enforcement between the Pacific Stock Exchange and the Taiwan Stock Exchange, dated October 22, 1993.

the two exchanges. While the TSE has represented that there are no TSE rules or Taiwanese laws that might act to restrict the flow of market surveillance information, any request that involves information on an investor's identity or any information that is confidential or classified must be approved by the Taiwan Securities and Exchange Commission ("TSEC"). The TSEC will review the request on a case-by-case basis in deciding whether to permit the TSE to provide the information to the PSE. As such, pertinent transaction, clearing, or customer identity information that may be necessary for the PSE to review during an investigation might need approval by the TSEC before it could be relayed to the PSE.

In most situations, in the absence of a fully effective surveillance sharing agreement between exchanges, the Commission finds it difficult to conclude that a derivative product, such as the Dow Jones & Co. Taiwan Index options, is not susceptible to manipulation. Other factors, however, mitigate such a conclusion in this instance and support approval of the PSE's proposal. First, while the size of the underlying market is not necessarily determinative of whether a particular derivative product is readily susceptible to manipulation, the size of the market underlying the Dow Jones & Co. Taiwan Index makes it less likely that the proposed Index options are readily susceptible to manipulation.

Second, the PSE and the TSE, as discussed above, have signalled their intentions to prevent cross-border fraud and manipulation by entering into a MOU.

Third, although it appears that the TSEC has the ability to limit or condition the information to be provided by the TSE to the PSE, the TSEC has stated to the Commission that it would share surveillance information with the Commission on a case-by-case basis.<sup>20</sup> Moreover, in connection with the Commission's review of a proposal by the CME to trade futures on the Dow Jones & Co. Taiwan Index, the CME provided an opinion of counsel that indicates that the TSEC has the authority to obtain market oversight information that the Commission might request.<sup>21</sup> Consequently, it appears as though the TSEC can obtain the

<sup>20</sup>Such information would include transaction, clearing, and customer identity information necessary to conduct an investigation.

<sup>21</sup>See letter from Carl A. Royal, Senior Vice President, Chicago Mercantile Exchange, to Jane C. Kang, Special Counsel, CFTC, and Howard Kramer, Associate Director, Division of Market Regulation, Commission, dated September 12, 1996.

necessary information and is willing to provide it to the Commission. The Commission believes that this, along with the PSE's agreement with the TSE, should help to detect as well as to deter potential manipulation.

While the situation described above is not ideal, the Commission believes that it is adequate in light of the circumstances and considering the large capitalizations, substantial trading volume, wide diversity of the component stocks in the Dow Jones & Co. Taiwan Index, and the size of the market underlying the Index.<sup>22</sup>

The Commission finds good cause to approve Amendment No. 1 to the proposed rule filing prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. Amendment No. 1 to the PSE's proposal describes details of certain Index maintenance procedures. In this regard, the Commission believes that the Exchange's review of the Index's component securities for liquidity, capitalization, and concentration levels will help to ensure that the Index maintains its intended market character as well as remains an appropriate trading vehicle for public customers. In addition, Amendment No. 1 changes the Exchange's dissemination procedures. Rather than calculating and disseminating the Index value every fifteen seconds throughout the trading day, the Exchange will disseminate the Index value only at the beginning of each trading day. The Commission believes that in light of the PSE's assurances that the Index value will be widely available to investors throughout the trading day through data vendors as well as through the Dow Jones Global Index web site, and because stock exchange trading in Taiwan and U.S. markets do not overlap, approval of the amendment is appropriate. The changes proposed by Amendment No. 1 are minor, technical, or clarify and, for the reasons noted above, do not raise any new regulatory issues. The Commission also notes that no comments were received on the original PSE proposal, which was subject to the full 21-day notice and comment period. Accordingly, the Commission believes that it is consistent with Section 6(b)(5) of the Act to approve Amendment No.

<sup>22</sup> The Commission has similarly explored alternatives in other instances when the relevant foreign exchange was unwilling or unable to enter into a comprehensive surveillance sharing agreement. See, e.g., Securities Exchange Act Release No. 36070 (August 9, 1995), 60 FR 42205 (August 15, 1995) (order approving proposed rule change relating to the listing and trading of warrants on the Deutscher Aktienindex).

1 to the proposed rule change on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1 to the rule proposal. 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. 20549. Copies of such filing also will be available for inspection and copying at the principal office of the PSE. All submissions should refer to File No. SR-PSE-96-40 and should be submitted by January 23, 1997.

#### IV. Conclusion

For the foregoing reasons, the Commission finds that the PSE's proposal to list and trade index options based on the Dow Jones & Co. Taiwan Index is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>23</sup> that the proposed rule change (SR-PSE-96-40), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>24</sup>

Jonathan G. Katz,  
Secretary.

[FR Doc. 96-33314 Filed 12-31-96; 8:45 am]

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## DEPARTMENT OF STATE

[Public Notice No. 2493]

### Shipping Coordinating Committee Subcommittee on Safety of Life at Sea Working Group on Fire Protection; Meeting

The U.S. Safety of Life at Sea (SOLAS) Working Group on Fire Protection will conduct an open meeting on January 22, 1997, at 9:30 a.m., in Room 4315 at U.S. Coast Guard Headquarters, 2100 2nd

<sup>23</sup> 15 U.S.C. 78s(b)(2) (1988).

<sup>24</sup> 17 CFR 200.30-3(a)(12).

Street, SW, Washington, DC 20593. The purpose of the meeting will be to discuss the outcome of the Forty-first Session of the International Maritime Organization's Subcommittee on Fire Protection, held on September 30, 1996. In addition, preparations for the next session will also be discussed at the meeting.

The meeting will focus on proposed amendments to the 1974 SOLAS Convention for the fire safety of commercial vessels. Specific discussion areas include: the new mandatory Fire Test Procedures Code, proposed restructuring of Chapter II-2, halon fire extinguishing systems, emergency escape breathing devices, fire retardant materials for fishing vessel lifeboats, criteria for maximum fire loads, fire safety measures for deep fat cooking equipment, interpretations to SOLAS 74, role of the human element in maritime casualties, safety of passenger submersible craft, recognition of test laboratories, fixed fire detection and alarm systems for new and existing cargo ships, and shipboard safety emergency plans.

Although the meeting will focus primarily on the outcome of the previous session, preparations and plans for the next will also be discussed. This offers the opportunity for members of the public to be involved early in the standards development process. Members of the public wishing to make a statement on new issues or proposals at the meeting are requested to submit a brief summary to the U.S. Coast Guard five days prior to the meeting.

Interested members of the public are encouraged to attend. For further information regarding the meeting of the SOLAS Working Group on Fire Protection contact Mr. Jack Booth at (202) 267-2997.

Dated: December 18, 1996.

Russell A. La Mantia,  
Chairman, Shipping Coordinating Committee.  
[FR Doc. 96-33313 Filed 12-31-96; 8:45 am]  
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## DEPARTMENT OF TRANSPORTATION

### Office of the Secretary

### White House Commission on Aviation Safety and Security; Open Meeting

AGENCY: Office of the Secretary (OST), DOT.

ACTION: Notice of meeting.

SUMMARY: The White House Commission on Aviation Safety and Security will hold a meeting to discuss