

consistent with Section 6(b)(5) of the Act to approve Amendment No. 2 to the proposed rule change on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2 to the proposed rule change. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules changes that are filed with the Commission, and all written communications relating to Amendment No. 2 between the Commission and any persons, 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, NW., Washington, DC 20549. Copies of such filing will also be available at the principal office of the Exchange. All submissions should refer to File No. SR-Phlx-97-23 and should be submitted by February 13, 1998.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-Phlx-97-23), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁵

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39549; File No. SR-Phlx-96-38]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2, 4 and 5 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc., Relating to the Listing of Flexible Exchange Traded Equity and Index Options

January 14, 1998.

I. Introduction

On August 21, 1996, 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 Flexible Exchange Options ("FLEX options") on specified indexes ("FLEX index options") and equity securities ("FLEX equity options").

Notice of the proposal was published for comment and appeared in the **Federal Register** on September 24, 1996.³ The Phlx submitted to the Commission Amendment No. 1 to its proposal on March 6, 1997.⁴ Notice of Amendment No. 1 was published for comment and appeared in the **Federal Register** on April 24, 1997.⁵ The Phlx submitted to the Commission Amendment No. 2 to its proposal on July 1, 1997.⁶ The Phlx submitted Amendment No. 3, on August 27, 1997,⁷ which was subsequently replaced in its

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 37691 (September 17, 1996), 61 FR 50060.

⁴ In Amendment No. 1 to its proposed rule change, the Phlx restated the original proposal and proposed several changes as set forth in detail in Section III of this release.

⁵ See Securities Exchange Act Release No. 38519 (April 17, 1997), 62 FR 20048.

⁶ In Amendment No. 2, the Exchange amended the Request for Quote process to require a Requesting Member to indicate the size of an order and the intention to cross, if applicable. In addition, the Phlx proposes specific position limits of 22,000 contracts for Super Cap Index options. See Letter from Edith Hallahan, Director and Special Counsel, Regulatory Services, Phlx, to Sharon Lawson, Senior Special Counsel, Office of Market Supervision ("OMS"), Division of Market Regulation ("Market Regulation"), Commission, dated June 25, 1997 ("Amendment No. 2").

⁷ See Letter from Theresa McCloskey, Vice President, Phlx, to Sharon Lawson, Senior Special Counsel, OMS, Market Regulation, Commission, dated August 26, 1997 ("Amendment No. 3").

entirety by Amendment No. 4, which the Phlx submitted to the Commission on November 7, 1997.⁸

The Phlx submitted Amendment No. 5 to the Commission on January 6, 1998.⁹

No comment letters were received on the proposed rule change or on Amendment No. 1 to the proposed rule change. This order approves the Exchange's proposal, as amended by Amendment Nos. 1 through 5.

II. Background

The purpose of the Exchange's proposal is to provide a framework for the Exchange to list and trade equity and index options that give investors the ability, within specified limits, to designate certain of the terms of the options. In recent years, an over-the-counter ("OTC") market in customized options has developed which permits participants to designate the basic terms of the options, including size, term to expiration, exercise style, exercise price, and exercise settlement value, in order to meet their individual investment needs. Participants in this OTC market are typically institutional investors, who buy and sell options in large-size transactions through a relatively small number of securities dealers. To compete with this growing OTC market in customized options, the Exchange

⁸ The Phlx replaces Amendment No. 3, in its entirety, with Amendment No. 4, and proposes to: (1) eliminate the application of position and exercise limits to FLEX equity options; (2) reduce the minimum size applicable to a Request-for-Quote for a closing transaction in already-opened FLEX equity options from 100 to 25 contracts; (3) clarify the parity and priority principles for FLEX options transactions; (4) amend the proposed rule change to refer consistently to "FLEX index and equity options" (as opposed to index FLEX options); (5) correct the text of proposed Rule 1079(b)(6) regarding the crossing procedure to reflect that the crossing intention has already been announced as part of the RFQ, as amended by Amendment No. 2; and (6) amend proposed Rule 1079(a)(1) to clearly state that any options-eligible security pursuant to Rule 1009 is eligible to underlie FLEX equity options trading and any index underlying Non-FLEX options trading is also eligible for FLEX index options trading. These proposed changes are described more fully herein. See Letter from Philip H. Becker, Senior Vice President, General Counsel and Chief Regulatory Officer, Phlx, to Sharon Lawson, Senior Special Counsel, OMS, Market Regulation, Commission, dated November 3, 1997.

⁹ The Phlx proposes in Amendment No. 5 to replace section 3 of Amendment No. 4 and withdraw the examples provided in Amendment 4. In Amendment No. 5, the Phlx clarifies: (1) the parity and priority principles for FLEX options transactions; and (2) that each assigned ROT or assigned Specialist is not required to respond with a quote in every instance, unless requested by a Floor Official. See Letter from Michele R. Weisbaum, Vice President and Associate General Counsel, Phlx, to Sharon Lawson, Senior Special Counsel, OMS, Market Regulation, Commission, dated December 9, 1997 ("Amendment No. 5").

²⁴ 15 U.S.C. § 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).

proposes to adopt rules¹⁰ to permit the introduction of trading in FLEX options in an exchange auction market environment, with The Options Clearing Corporation ("OCC") as issuer and guarantor.¹¹ Thus, FLEX options are structured with a minimum size reflecting the larger-sized trades of these institutional users. The Exchange's proposal will allow FLEX option market participants to designate the following contract terms: (1) exercise price (except for certain limitations for FLEX equity call options);¹² (2) exercise style (*i.e.*, American¹³ or European,¹⁴); (3) expiration date;¹⁵ (4) option type (put, call, or hedge order); and (5) form of settlement (for index options—A.M., P.M. or average).

The proposed rule, Rule 1079, is based upon the Exchange's Rule 1069, Customized Foreign Currency Options, and Exchange experience with trading this product since November, 1994.¹⁶ Generally, FLEX options shall be traded in accordance with many existing option and index option rules; however, Rule 1079 contains certain new trading procedures unique to FLEX options. In addition, the Exchange believes that the proposal is similar to the rules and proposals of other exchanges respecting flexible options.¹⁷

OCC will be the issuer and guarantor of all FLEX index and equity options. Similarly, the Commission has

previously, designated FLEX index and equity options as standardized options for purposes of the options disclosure framework established under Rule 9b-1 of the Act.¹⁸

III. Description of the Proposal¹⁹

The Phlx proposes to adopt Rule 1079, FLEX™ index and equity²⁰ options, which would govern the trading of FLEX index and equity options on the Exchange. The Exchange proposes to designate all Phlx index options as eligible for FLEX options trading.²¹ Thus, the Phlx is proposing to trade FLEX options on industry (narrow-based) index options pursuant to the proposed rule, in addition to market (broad-based) index options. Further, the Phlx is proposing to trade FLEX equity options on securities which are options-eligible pursuant to Rule 1009.

Proposed Rule 1079 contains the characteristics, trading procedure and other provisions applicable to trading FLEX options. All FLEX options must be quoted and traded in the trading crowd of the corresponding non-FLEX option. The Exchange notes that the Automated Options Market ("AUTOM") system will not be available for FLEX options. Proposed Rule 1079 also states that although FLEX options are generally subject to the rules in the

options section,²² to the extent that the provisions of Rule 1079 are inconsistent with other applicable Exchange rules, Rule 1079 takes precedence with respect to FLEX options.

Because FLEX options would not be continuously quoted, nor are series pre-established, the variable terms of FLEX options shall be established by the following process. In order to initiate a transaction, a Requesting Member must submit an RFQ to the appropriate trading crowd, announcing the terms of the quote sought. The characteristics, including which terms and to what degree customization will be available, are outlined in Rule 1079(a).²³ For example, the exercise strike price respecting FLEX index options can be specified at the time the quote is requested in terms of a specific index value number (*e.g.*, 553.5), a method for fixing such number (*e.g.*, 10 basis points over the index value at a certain time, or with the future trading at a certain price), or a percentage of index value calculated as of the open or close of trading on the Exchange on the trade date (*e.g.*, 5% above the close).²⁴ Similarly, respecting FLEX equity options, the exercise strike price can be specified in terms of a specific dollar amount rounded to the nearest one-eighth of a dollar, or a percentage of the underlying security rounded to the nearest tick. However, the Exchange proposes to amend its original proposal to state that customization of FLEX equity option strike prices for calls will not be permitted; only strikes that may be listed pursuant to Rule 1012 are eligible, such that the strike price must be consistent with strike price intervals permissible for standardized non-FLEX equity options.²⁵

The exercise style can be either American or European,²⁶ regardless of the exercise style of the listed option.²⁷ The expiration date can also be customized, specifying any business day (non-holiday)—any month, day and year within five years for Flex index options and three years for FLEX equity options.

²² See Phlx Rules 1000, *et. seq.*

²³ The Exchange represents that Rule 1079 generally parallels the provisions of Rule 1069 governing customized foreign currency options.

²⁴ Initially, the exercise strike price will not be available for customization as a percentage, pending systems enhancements.

²⁵ See Rule 1012, Commentary .05.

²⁶ An American style option may be exercised at any time up to its expiration, while a European style option can only be exercised on its expiration day. See Phlx Rule 1000(b)(35).

²⁷ In certain circumstances, European style FLEX equity options may be adjusted to require the delivery upon exercise of a fixed amount of cash. See OCC By-Law, Article VI, Section 11, Interpretation and Policy. 08.

¹⁰ See Phlx Rule 1079.

¹¹ For a discussion of clearance and settlement procedure for FLEX options, see Securities Exchange Act Release No. 37318 (June 18, 1996) (SR-OCC-96-03). For example, OCC may depart from regular expiration date procedures and deadlines in the case of equity FLEX options, pursuant to OCC Rule 805, Interpretation and Policy .03.

¹² The Exchange believes that the flexible exercise price feature could result in an available call option that would not be eligible to be a qualified covered call ("QCC") under Section 1092(c)(4) of the Internal Revenue Code, thus jeopardizing a modest tax benefit currently enjoyed by writers of standardized non-FLEX equity call options. Accordingly, the Phlx's rules will restrict exercise prices for FLEX equity call options. See also Securities Exchange Act Release No. 37726 (September 25, 1996) (File No. SR-Amex-96-29; SR-CBOE-96-56; and SR-PSE-96-31).

¹³ An American-style equity option is one that may be exercised at any time on or before the expiration date.

¹⁴ A European-style equity option is one that may be exercised only during a limited period of time prior to expiration of the option.

¹⁵ The proposal, however, requires that the expiration date of a FLEX equity option may not fall on a day that is on, or within two business days of the expiration date of a Non-FLEX equity option. In addition, FLEX index options must have an expiration date within 5 years of issuance, and FLEX equity options within 3 years of issuance.

¹⁶ Securities Exchange Act Release No. 34925 (November 1, 1994) (SR-Phlx-94-18).

¹⁷ See, *e.g.*, CBOE Rules 24A.1-24A.17; Amex Rules 900G, *et. seq.*; and PSE Rules 8.100-8.115.

¹⁸ FLEX index options and FLEX equity options have been deemed "standardized options" for purposes of the Rule 9b-1 options disclosure framework. See *e.g.*, Securities Exchange Act Release Nos. 31920 (February 24, 1993) (Order approving FLEX options based on the S&P 100 and 500 Indexes); 31910 (February 23, 1993) (FLEX index option 9b-1 order); and 36841 (February 14, 1996) (Order approving FLEX equity options for CBOE and PCX, and designating FLEX equity options, and FLEX index options traded and settled in certain designated foreign currencies, as "standardized options"). See also Securities Exchange Act Release No. 37824 (October 15, 1996) (FLEX equity option 9b-1 order).

¹⁹ The original proposal was published for comment in Securities Exchange Act Release No. 37691 (September 17, 1996) (File No. SR-Phlx-96-38).

²⁰ The term "FLEX" is a trademark of the Chicago Board Options Exchange, Inc. ("CBOE").

²¹ The following are the current Phlx market index options: Value Line Composite Index ("VLE"), National Over-the-Counter Index ("XOC"), and U.S. Top 100 Index ("TPX"). The following are the current Phlx industry index options: OTC Industrial Average Index ("OTZ"), Bank Index ("BKX"), Gold/Silver Index ("XAU"), Semiconductor Index ("SOX") and Utility Index ("UTY"), Forest and Paper ("FPP"), Plane ("PLN"), Phone ("PNX"), and Oil Service ("OSX"). Because the Super Cap Index ("HFV") is neither a market or an industry index, the Exchange applies a position limit of 5,500 contracts for the non-FLEX overlying option. This position limit is lower than the position limit tiers for standardized non-FLEX industry index options. In addition, the Exchange proposes to delete the provision that requires approval by the Options Committee prior to listing an otherwise eligible FLEX product. See Amendment No. 4, *supra* note 8.

However, FLEX options may not expire on any day that falls on or within two business days of (prior or subsequent to) a mid-month expiration day for a non-FLEX option on the same underlying index or security (other than a quarterly expiring index option).²⁸ In addition, a FLEX option cannot expire on the same day that series is established at OCC.²⁹

With respect to the minimum size of FLEX *market index* option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is \$10 million underlying equivalent value; if there is open interest, the minimum value size of an RFQ for an opening or closing transaction is \$1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less. The underlying equivalent value is defined as the aggregate underlying value of a FLEX index option (index multiplier times the current index value) multiplied by the number of FLEX index options. The minimum value size for a responsive quote in FLEX market index options is \$1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less.

With respect to the minimum size of FLEX *industry* index option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is \$5 million underlying equivalent value; this amount is one-half of the minimum size proposed by the Phlx and currently in place on other options exchanges for flexible broad-based index options. Where there is open interest, the minimum value size of an RFQ for an opening or closing transaction is \$1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less. The minimum value size for a responsive quote is \$1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less.

With respect to the minimum size of FLEX *equity* option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is 250 contracts; if there is open interest, the

minimum value size of an RFQ is 100 contracts in the case of an opening transaction; and 25 contracts, or the remaining size on a closing transaction, whichever is less. The minimum value size for a responsive quote in FLEX equity options is 25 contracts, or the remaining size on a closing transaction, whichever is less.³⁰ The Phlx also proposes that the minimum size for FLEX equity options exercises is reduced from the originally proposed 100 contracts to 25 contracts.

The Exchange proposes to lower the minimum size from 100 to 25 contracts under such circumstances, in part, to conform to the rules of other options exchanges.³¹ Further, the Exchange believes that the ability to close positions in increments smaller than 100 contracts should attract additional FLEX trading interest. The Exchange notes that market participants wanting to execute an opening transaction in a particular series of FLEX equity options will continue to be required to meet the 250 or 100 minimum contract requirement.

Assigned ROTs and assigned Specialists, who respond to an RFQ, are required to respond to each RFQ with a certain minimum size. Respecting FLEX market index options, assigned ROTs and assigned Specialist, who respond to an RFQ, are required to respond with at least \$10 million underlying equivalent value or the dollar amount requested in the RFQ, whichever is less. Respecting FLEX industry index options, assigned ROTs and assigned Specialists, who respond to an RFQ, are each required to respond with at least \$5 million underlying equivalent value or the dollar amount requested in the RFQ, whichever is less. Respecting FLEX equity options, assigned ROTs and assigned Specialist, who respond to an RFQ, are required to respond with a market of at least 250 contracts or the size amount requested in the RFQ, whichever is less.

The settlement value for FLEX index options may be specified as the value reported on the Exchange at the: (i) close of trading (P.M.-settled), (ii) opening of trading (A.M.-settled), or (iii) as an average over a specified period of time, within parameters established by the Exchange.³² For example, the third

category includes the average of the index's opening and closing settlement values on the expiration date, the average of the index's high and low values on the expiration date, or the average of the index's opening, closing, high and low values on the expiration date. However, American style FLEX index options exercised prior to the expiration date can only settle based on the closing value on the exercise date.³³ FLEX index options maybe designated for settlement in U.S. dollars, British pounds, Canadian dollars, Deutsche marks, European Currency Units, French francs, Japanese yen or Swiss francs. With respect to the settlement process applicable to FLEX equity options, exercise settlement shall be by physical delivery of the underlying security pursuant to Rule 1044. Also, FLEX equity options will be subject to the exercise-by-exception procedures of OCC.³⁴

With respect to the quote format of FLEX options, a bid and/or offer in the form of a specific dollar amount reflected as a fractional price (e.g., $\frac{1}{8}$, $\frac{1}{4}$), or a percentage of the underlying security or underlying equivalent value, rounded to the nearest minimum tick shall be acceptable. The option type may be a put, call or hedge order.³⁵

The quoting and trading procedure for FLEX options, beginning with the RFQ, is enumerated in Rule 1079(b). Submitting an RFQ is the first step in quoting FLEX options. The Requesting Member must first announced the RFQ to the trading crowd of the non-FLEX option and then submit an RFQ ticket, containing the following: (1) Underlying index or security, (2) type, (3) exercise style, (4) expiration date, (5) exercise price, and, respecting FLEX index options, (6) settlement value (e.g., A.M. or P.M.), and (7) the designated settlement currency. Thereafter, on receipt of an RFQ in proper form, the assigned Specialist or the Requesting

additional index value calculations required due to the type of customization offered by FLEX options. The Exchange is not proposing, at this time, to utilize its own Index Calculation Engine ("ICE") System as the reporting authority for FLEX options. See Securities Exchange Act Release No. 38292 at n.4 (February 15, 1997) (SR-Phlx-96-36).

³³ This limitation is currently in place on other exchanges trading FLEX options and with respect to other American style A.M.-settled index options. See Characteristics and Risks of Standardized Options Trading, February 1994, at page 48.

³⁴ OCC Rule 805 provides for automatic exercise of in-the-money options at expiration without the submission of an exercise notice to OCC if the price of the security underlying the option is at or above a certain price (for calls) or at or below a certain price (for puts); and the non-exercise of an option at expiration if the price of the security underlying the option does not satisfy such price levels.

³⁵ See Rules 1000(b)(7) and 1066(f).

²⁸ Quarterly expiring index options expire on the first business day of the month following the end of the calendar quarter.

²⁹ This provision replaces language in Rule 1079(a)(6)(C) of the original proposal stating that a new series cannot be opened on the day of exercise.

³⁰ The Exchange originally proposed minimum closing (if there is open interest) and responsive transaction sizes of 100 contracts. See Amendment No. 4, *supra* note 8.

³¹ See, e.g., Securities Exchange Act Release No. 38839 (July 15, 1997), 62 FR 39040 (July 21, 1997) (order approving File No. SR-CBOE-97-10).

³² The Exchange proposes to retain its existing securities information vendor as the reporting authority for FLEX index options, respecting any

Member shall cause the terms of the RFQ to be disseminated as an administrative text message through the Options Price Reporting Authority ("OPRA").³⁶ RFQs, responsive quotes, booked orders and completed trades will be promptly reported to OPRA and disseminated as an administrative text message. The Exchange notes that although certain information is not required to be part of the RFQ (such as account type, crossing intention, response time and size), this information will be reflected on the final order ticket. Further, the size and crossing intention must be voiced as part of voicing the RFQ.³⁷

Following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes. As stated in paragraph (b)(2), the response time, between two and 15 minutes, will be determined by the Options Committee.³⁸ During the response time, qualified members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn during such response time. At the end of the response time, the assigned Specialist, or if none, the Requesting Member shall determine the best bid and offer ("BBO"), based on price, disseminating such market with reference to the corresponding RFQ. However, where two or more bids/offers are at parity, proposed Phlx Rule 1079(b)(3) states that bids/offers submitted by an assigned Specialist, assigned ROT or customer will have priority over the bids/offers submitted by non-assigned ROTs and by controlled accounts as defined in Phlx Rule 1014(g)(i).³⁹ The Exchange has also explicitly set forth in the text of the proposed rule and Advice F-28 stating that all transactions must be in compliance with Section 11 of the Act and the rules promulgated thereunder.

Following the determination of the BBO, a BBO Improvement Interval may

be invoked if the Requesting Member rejects the BBO or the BBO is for less than the entire size requested. The BBO Improvement Interval is a two minute time period during which the BBO may be matched or improved. As a result of the Improvement Interval, a new BBO is established, which is disseminated with reference to the corresponding RFQ. An assigned ROT and the assigned Specialist who responded with a market during the response time may immediately join the new BBO.

A trade in FLEX options cannot be executed until the end of the response time or BBO Improvement Interval. Once the response time or BBO Improvement Interval ends, the Requesting Member is given the first opportunity to trade on the market by voicing a bid/offer in the trading crowd.⁴⁰ The Requesting Member has no obligation to accept any bid or offer for a FLEX option. If the Requesting Member rejects the BBO or the BBO size exceeds the entire size requested, another member may accept such BBO or the unfilled balance of the BBO. Acceptance of a bid/offer creates a binding contract under Exchange rules.

Once the BBO is established, the RFQ remains open that trading day, unless a trade occurs, and a member may re-quote the market with respect to the open RFQ without submitting an additional RFQ. If a trade occurs, a new RFQ is required. Only an assigned ROT or assigned Specialist who responded to the open RFQ during the response time or BBO Improvement Interval may immediately join the re-quoted market, thus matching for parity purposes. Neither the Requesting Member, nor the re-quoting member, is given the first opportunity to trade on the re-quoted market.

Further, there will be a limit order book for FLEX options. The Specialist in the listed non-FLEX equity or index option, whether or not assigned in FLEX options, must accept FLEX orders on the FLEX book after completion of the RFQ process. Only customer day limit orders may be placed on the FLEX index or FLEX equity option book. Booked orders expire at the end of each trading day. The limit price and size must be written on the RFQ ticket and disseminated as an administrative text message through OPRA. In order to trade with the book, an executing member must quote the market and announce the trade. The Exchange proposes to delete the

provision that the executing member has priority over other members, including assigned ROTs and the assigned Specialist, seeking to trade with the booked order. The purpose of this change is to trade FLEX options off the book similarly to non-FLEX options, noting that this consistency should prevent confusion.

Generally, on the Phlx options floor, a cross may take place in accordance with Rule 1064. The Requesting Member must voice the crossing intention as part of voicing the RFQ. With respect to FLEX options, after the BBO has determined, the Requesting Member intending to cross must bid (or offer) at or better than the BBO. If the Requesting Member's bid/offer is at the BBO, the Requesting Member may execute 25% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. For instance, if there are two members on parity at the BBO, the Requesting Member and an assigned ROT, the Requesting Member is entitled to receive 50% of the contra-side contracts, which is a fair split, not just the 25% guaranteed minimum right of participation. The remainder of the contra-side is split in accordance with the parity/priority provision applicable to determining the BBO, such that assigned ROTs/Specialists may be afforded priority.

If the Requesting Member's bid/offer improves the existing BBO, an assigned ROT or assigned Specialist who responded with a market during the response time or BBO Improvement Interval, may immediately join the Requesting Member's improved bid or offer, thus matching for parity purposes. However, the Requesting Member may execute 25% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision applicable to determining the BBO, such that assigned ROTs/Specialists may be afforded priority. However, broker-dealer crosses and solicited orders, as defined in Rule 1064, are not eligible for the split afforded by these crossing provisions. Broker-dealer crosses and solicited orders must be announced and bid/offered, under the FLEX crossing provision. No 25% minimum guaranteed right of participation applies to solicited orders or broker-dealer/broker-dealer crosses. In addition, crossing transactions may not be subject to a minimum right of participation, because a customer-to-customer cross would not be required to yield the

³⁶ Operationally, the Requesting Member provides this information to data entry personnel, who enter it into Exchange systems.

³⁷ See Amendment No. 2, *supra* note 6, and Amendment No. 4, *supra* note 8.

³⁸ Initially, the Options Committee has established a response time of ten minutes. Although this Committee will be authorized to change the response time within the permissible range, any such change will be preceded by notice to the Exchange membership. See also CBOE Rule 24A.4(a)(3)(iii).

³⁹ In Amendment No. 5, the Phlx states that assigned Specialist and Assigned ROTs generally should not receive priority over customer orders in FLEX options transactions, because of their duty under the Act and Exchange rules to assist in the maintenance of a fair and orderly market by responding to temporary disparities between supply and demand, a lack of price continuity or a temporary distortion in pricing relationships. See Amendment No. 5, *supra* note 9.

⁴⁰ Thus, when a Requesting Member seeks to trade on the established BBO, an assigned ROT/Specialist cannot participate. For example, where the BBO is 6-7, if the Requesting Members seek to sell 500 contracts at 6, the Requesting Member has priority for that purpose.

remainder (75%) to assigned ROTs/Specialists.

The Exchange notes that an ROT and Specialist may trade FLEX options as an assigned ROT/Specialist or as a non-assigned ROT/Specialist. However, the FLEX assigned Specialist must be the specialist in the non-FLEX option. ROTs and Specialists must apply on the appropriate Exchange form to be assigned in FLEX options. An assigned ROT or assigned Specialist may choose to be assigned in a particular FLEX option, but must respond with a market respecting any FLEX option upon request by a Floor Official.

Assigned ROTs and the assigned Specialist will be subject to certain obligations respecting the trading of FLEX options. For example, the affirmative and negative market making obligations of Rule 1014(c) apply. Further, as noted above, assigned ROTs and the assigned Specialist, who respond to an RFQ, are required to respond with a market of the minimum size.⁴¹ At least two Exchange members (ROTs and/or a Specialist) shall be assigned to each FLEX option. If there is an assigned Specialist and an assigned ROT, the FLEX option will trade pursuant to the specialist system, just as non-FLEX options currently do on the Exchange. If, however, there is no assigned Specialist in a FLEX option, two assigned ROTs are required for that FLEX option to trade.

Assigned ROTs and the assigned Specialist who responded with a market during the response time may join a new bid/offer voiced during the Improvement Interval and prior to a cross, provided they do so immediately and subject to preserving the priority of customer orders. Enabling assigned ROTs and the assigned Specialist to join such new bid/offer affords them parity at that new BBO.

Generally, FLEX option positions are not taken into account when calculating position limits for non-FLEX index options on the same index.⁴² Accordingly, FLEX market index options currently approved for non-FLEX options trading will be subject to a separate position limit of 200,000 contracts on the same side of the

market.⁴³ FLEX industry index options will be subject to a position limit of four times the current position limit—36,000, 48,000 or 60,000 contracts on the same side of the market.⁴⁴

The Exchange notes that FLEX market index option limits are the same as the provisions of other exchanges.⁴⁵ The Exchange also believes that four times the non-FLEX limit is an appropriate limit for FLEX industry index options.⁴⁶

Respecting FLEX equity options, the Exchange proposes to eliminate the application of position and exercise limits under a two-year pilot program.⁴⁷ Rule 1079(d)(2) would continue to state that position limits for non-FLEX equity options shall not be taken into account when calculating position limits for non-FLEX equity options, or FLEX or non-FLEX index options.

The Exchange is proposing to add that each member or member organization (other than a Specialist or Registered Options Trader) that maintains a position on the same side of the market in excess of three times the level established pursuant to Rule 1001 for non-FLEX equity options of the same class on behalf of its own account of a customer shall report information on the FLEX equity option position, positions

⁴³ The following are the current Phlx market (broad-based) index options: Value Line Composite Index ("VLE"), National Over-the-Counter Index ("XOC"), and U.S. Top 100 Index ("TPX"). If the Exchange wants to list and trade FLEX options on a broad-based index subsequently approved for non-FLEX options trading, the Exchange must submit a Rule 19b-4 filing with the Commission proposing appropriate FLEX market index options position limits.

⁴⁴ The following are the current Phlx industry (narrow-based) index options: OTC Industrial Average Index ("OTZ"), Bank Index ("BKX"), Gold/Silver Index ("XAU"), Semiconductor Index ("SOX"), Utility Index ("UTY"), Forester and Paper ("FPP"), Plane ("PLN"), Phone ("PNX"), and Oil Service ("OSX"). Because the Super Cap Index ("HFV") is neither a market or an industry index, the Exchange applies a position limit (5,500 contracts) that is lower than the position limit tiers for standardized non-FLEX industry index options. Accordingly, the position limit for FLEX options overlying the Super Cap Index will be 22,000 contracts (4 times 5,500 contracts—the existing non-FLEX position limit). See Amendment No. 2, *supra* note 6.

⁴⁵ See e.g., CBOE Rule 24A.7(b).

⁴⁶ See Phlx rule 1001A(b). In 1996, these limits were raised from 6,000, 9,000 or 12,000 contracts to 9,000, 12,000 or 15,000 contracts. Securities Exchange Act Release No. 37863 (October 24, 1996) (File No. SR-Phlx-96-33). Thus, the proposed change in the corresponding FLEX limits is a change from the original proposal reflecting four times the previous limits.

⁴⁷ See Amendment No. 4., *supra* note 8. The Exchange originally proposed position limits of three times the position limit applicable to non-FLEX equity options, pursuant to Rule 1001. The Phlx will provide the Commission with status report after one-and-a-half years of the pilot for the Commission to assess the effects on the markets of the elimination of position and exercise limits on FLEX equity options.

in any related instrument, the purpose or strategy for the position and the collateral used by the account. This report shall be in the form and manner prescribed by the Exchange. In addition, whenever the Exchange determines that a higher margin requirement is necessary in light of the risks associated with a FLEX equity option position in excess of three times the level established for non-FLEX equity options of the same class, the Exchange may impose such higher margin requirement and/or may assess capital charges upon the member organization carrying the account to the extent of any margin deficiency resulting from the higher margin requirement.

The Exchange notes that the purpose of the amendment is to compete with the other option exchanges' that have been approved for identical position limit treatment for FLEX equity options,⁴⁸ and to attract additional investor interest, and to structure FLEX equity options in a more flexible fashion. There will still, however, be position and exercise limits for FLEX index options, as described above.

The Exchange believes that the elimination of position/exercise limits for FLEX equity options is appropriate in light of the institutional nature of the product. Phlx states that one particular potential institutional use of FLEX options is for stock repurchase programs, which can be utilized by stock issuers in the form of put sales. The Exchange believes that eliminating position limits may attract this business, and thus, bring significant options volume into the realm of exchange trading.⁴⁹

The Exchange believes that attracting additional market participation to FLEX equity options should improve liquidity and the quality of FLEX markets for all participants. The amendment would require member organizations to report positions exceeding three times the non-FLEX position limit in that option. Whenever a member files such a report with the Exchange, the Exchange may request a higher margin requirement in light of the risks associated with such a FLEX equity options position. Thus, the Exchange believes that the amendment is reasonable and consistent with the market protection and anti-manipulation purposes of position/exercise limits. Enhanced reporting is

⁴⁸ See Securities Exchange Act Release No. 39032 (September 9, 1997) (File Nos. SR-Amex-96-19; SR-CBOE-96-79; SR-PCX-97-09) ("FLEX Equity Option Position Limit Approval Order").

⁴⁹ The Commission notes that issuers would, of course, need to comply with all applicable provisions of the federal securities laws in conducting their share repurchase programs.

⁴¹ However, assigned ROTs and assigned Specialists are not required to provide continuous quotes or markets at a certain minimum bid-ask differential (quote spread parameter).

⁴² However, positions in P.M.-settled customized index options shall be aggregated with positions in quarterly expiring options ("QIXs") on the same index, if the customized option expires at the close of trading on or within two business days of the last trading day in a quarter. The Exchange is authorized to trade QIXs on certain index options pursuant to Rule 1101A(b)(iv), although none currently trade.

intended to facilitate the Exchange's surveillance function respecting larger FLEX positions.

The exercise limit for FLEX index options would apply, equivalent to the applicable FLEX index option position limit. The minimum exercise size, however, would be the lesser of \$1 million or the remaining size of the position respecting index options, and the lesser of 25 contracts or the remaining size of the position respecting equity options.

The proposal requires any ROT and Specialist to submit a Letter of Guarantee⁵⁰ issued by a clearing member organization, specifically accepting financial responsibility for all FLEX option transactions made by such person. Moreover, an assigned Specialist in FLEX index options shall be required to maintain a minimum of \$1,000,000 in net capital. An assigned ROT in FLEX index options will be required to maintain a minimum of \$100,000 in net liquid assets. Floor Brokers must maintain a minimum of \$50,000 in net capital to qualify to trade FLEX options. Assigned ROTs, the assigned Specialist and Floor Brokers must immediately notify the Exchange's Examinations Department upon failure to be in compliance with these requirements. The Exchange may waive the financial requirements of this Rule in unusual circumstances. Assigned Specialists/ROTs in FLEX equity options, as well as non-assigned ROTs/Specialists in FLEX options, are required to comply with Exchange financial requirements.⁵¹

The Exchange also proposes to adopt Floor Procedure Advice F-28, Trading FLEX Index and Equity Options, to parallel most of the provisions of Rule 1079(b), including those pertaining to requesting quotations, responses, determining the BBO, the BBO Improvement Interval, executing a trade and crossing. Advice F-28 is not proposed to contain a fine schedule, such that it does not require inclusion in the Exchange's minor rule violation enforcement and reporting plan.

There will be no trading rotations in FLEX options, either at the opening or at the close of trading. The Exchange has determined that, initially, FLEX options will begin trading at 10:00 a.m., one half hour after the normal opening of trading non-FLEX options on the Exchange, in order to limit the burden on the trading crowd. FLEX industry index and equity options will trade until 4:02 p.m., to correspond to the non-FLEX options similar to FLEX

market index options, which would trade until 4:15 p.m. The Exchange may establish other trading times for FLEX options within the regular trading hours for the non-FLEX options, including coordination with FLEX trading hours on other exchanges and reflecting new trading hours for non-FLEX options.⁵²

In addition, the RFQ process, which allows a set period of time for bids and offers to be determined, is also designed to create an orderly trading environment, recognizing that greater variation in option terms requires sufficient time to respond with a quote. The Phlx believes, therefore, that the response time and the BBO Improvement Interval should thus promote depth and liquidity.

In order to provide adequate liquidity in FLEX options, two assigned members, whether ROTs or Specialists, are required for each FLEX option, and must be present for a trade to occur.⁵³ In addition, the minimum size requirements are intended to attract depth and liquidity to FLEX options.

Other FLEX provisions are intended to minimize the market impact of this product. For one, the expiration date may not fall on or within two business days before or after the normal mid-month Friday expiration for options. Because the expiration date of FLEX options may not correspond to a non-FLEX expiration, FLEX options should not affect the market for the underlying securities at the same time. This, in turn, minimizes the impact of FLEX options on the marketplace.

Second, position and exercise limits will apply to FLEX index options, although separate from those applicable to non-FLEX index options. The Exchange believes that separate, higher limits and non-aggregation are appropriate for FLEX index options, which are intended to compete with OTC options that are not subject to such limits. The higher limits reflect the institutional nature and resulting larger size of FLEX index options.

Although FLEX options are characterized by variable terms, not all FLEX option terms can be customized.

⁵² Under this proposal, expanding and narrowing FLEX trading hours within the regular trading hours of the particular product would not require a proposed rule change pursuant to Section 19(b) of the Act. The Exchange, however, will notify its members, in advance, prior to making any such change. Any proposal to expand trading hours outside of established regular trading hours would have to be submitted as a proposed rule change to the Commission pursuant to Section 19(b) of the Act.

⁵³ See Floor Procedure Advices A-10, Specialist Trading with Book, and C-1, Ascertaining the Presence of ROTs in a Trading Crowd, which require that, in addition to the Specialist, a ROT be present during a transaction.

As stated above, the expiration date cannot fall on certain days. Customization of FLEX equity option strike prices for calls will not be permitted, due to tax issues arising out of the definition of a qualified covered call. Thus, only equity option call strikes that may be listed pursuant to Rule 1012 are eligible, such that the strike price must be consistent with strike price intervals permissible for equity options. In addition, American-style FLEX index options exercised prior to the expiration date can only settle based on the closing value on the exercise date. Despite these restrictions on customization, the Phlx believes FLEX options should nevertheless address a market need for variation in contract terms.

The Exchange believes that FLEX options not only combine variable terms with an auction marketplace and OCC guarantee, but FLEX options will also offer transparency of quotes and trades, because the proposal requires prompt and complete quotation and transaction reporting. Although flexible options will not be continuously quoted, once an RFQ is received, its terms, as well as the responding quotes, will be disseminated by Exchange systems. The terms of any resulting trade will also be disseminated. Specifically, the assigned Specialist, or if none, the Requesting Member will ensure immediate dissemination to OPRA in the form of an administrative text message, which will, in turn, disseminate the information to subscribing vendors.

The Exchange expects to implement a separate computer system to handle FLEX index and equity options, similar to the system utilized for customized foreign currency options. The Exchange expects that initially FLEX options will be entered into this system at a limited number of locations on the trading floor, which will be described in detail by notice to the options trading floor.

The Exchange proposes to utilize a limit order book for FLEX option orders resulting from the RFQ process. The purpose of the book is to accommodate customers who have specified a limit price for a FLEX option order that is away from the market established during the RFQ process. The limit order book will be limited to customer day limit orders, which much be accepted by the Specialist, whether or not that Specialist is assigned in FLEX options. As such, the Specialist must monitor FLEX markets for any booked orders. The Exchange is requiring all Specialists, whether acting as an assigned FLEX Specialist or not, to maintain a FLEX book for consistency with the procedures for non-FLEX

⁵⁰ See Phlx Rule 703.

⁵¹ See Phlx Rule 703.

options and to prevent investor confusion. The Exchange believes that the FLEX order book should serve as a useful tool for customers, as does the current limit order book respecting non-FLEX options. With respect to booked orders for the same FLEX option (identical terms), Rule 1014 will apply to determine priority and parity among such orders.⁵⁴ When trading with a booked order, a member must re-quote the market and announce the trade.

The Exchange proposes to delete the provision in the original proposal that the executing member has priority over other members, including assigned ROTs and the assigned Specialist, seeking to trade with the booked order. The purpose of this change is to trade booked FLEX options similarly to non-FLEX options, noting that this consistency should prevent confusion.

The Exchange also proposes that an RFQ remain open that trading day, as opposed to expiring immediately, as long as a trade has not occurred. The market must be re-quoted before a member attempts to trade on an existing RFQ. The advantage of an RFQ remaining open is that a re-quote does not require the submission of a new RFQ, thereby avoiding the delay of a new response time where such time may not be needed due to a recent quote. Because an option quoted earlier in the trading day should be easier to price, such that a new response time is not required, the Exchange believes that it may be burdensome to repeat the RFQ process. Thus, RFQs remaining open streamlines FLEX trading and eliminates unnecessary delays. Any time a market is re-quoted that day, the new BBO and any resulting trade are disseminated with reference to the original RFQ. However, once a trade occurs, a new RFQ is required.⁵⁵

Certain aspects of proposed Rule 1079 differ from FLEX provisions of other exchanges. For instance, discretionary transactions would not be permitted in FLEX index and equity options.⁵⁶ Thus, the existing provisions of Rule 1065 will apply to prohibit such transactions.

Second, the Exchange also notes that there may not be a Specialist in FLEX

options. Where there is an assigned FLEX Specialist, that FLEX option will trade pursuant to the Phlx's specialist system. Where there is no assigned FLEX Specialist, two assigned ROTs are required. Only the assigned Specialist in the non-FLEX (listed) option may apply to be an assigned Specialist in the FLEX option.⁵⁷ but is not required to do so in order to participate. Instead, the non-FLEX Specialist may be an assigned ROT in the FLEX option, or not assigned at all. The current responsibilities of a Specialist to determine a market based on the bids and offers voiced as well as to disseminate bids/offers and trades may be handled by the Requesting Member, where there is no assigned Specialist in that FLEX option. If a trade occurs where the Requesting Member is not a participant and there is no assigned Specialist, the responsibility to submit the trade falls upon the seller or largest participant, in accordance with existing trading procure.⁵⁸

Third, the Exchange has also determined that FLEX options will trade in the crowd of the non-FLEX option in order to facilitate participation by assigned ROTs who will most likely be located in that crowd. The Exchange believes that encouraging market making activity, whether or not assigned, should foster liquidity in FLEX options.

IV. Discussion

The Commission finds that the proposals 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 Sections 6(b)(5)⁵⁹ and 11A⁶⁰ of the Act. Specifically, the Commission finds that the Exchange's proposal is designed to provide investors with a tailored or customized product for eligible index and equity options that may be more suitable to their investment needs. Moreover, consistent with Section 11A of the Act, the proposal should encourage fair competition among brokers and dealers and exchange markets, by allowing the Exchange to compete with the growing OTC market in customized index and equity options.

The Commission believes the Exchange's proposal reasonably addresses its desire to meet the demands of sophisticated portfolio managers and other institutional

investors who are increasingly using the OTC market in order to satisfy their hedging needs. Additionally, the Commission believes that the Exchange's proposal will help promote the maintenance of a fair and orderly market, consistent with Sections 6(b)(5) and 11A of the Act, because the purpose of the proposal is to extend the benefits of a listed, exchange market to index and equity options that are more flexible than current listed options and that currently trade OTC. The benefits of the Exchange's options market include, but are not limited to, a centralized market center, an auction market with posted transparent market, quotations and transaction reporting, parameters and procedures for clearance and settlement, and the guarantee of OCC for all contracts traded on the Exchange.⁶¹

The Commission believes the Exchange's trading procedures for FLEX index and equity options are reasonably designed to provide some of the benefits of an Exchange auction market along with features of a negotiated transaction between investors. In approving the proposal, the Commission recognizes that the Exchange's proposed FLEX option trading program will allow the trading of option contracts of substantial value, for which continuous quotations may be difficult to sustain. The Commission believes that the Exchange has adequately addressed these concerns by establishing procedures for quotes upon request, which must be firm for a designated period of time and which will be disseminated through OPRA.

The Commission also believes that it is reasonable that an RFQ remain open for that particular trading day once a BBO is established. Specifically, the Commission believes that if the Requesting Member does not accept the BBO, it is reasonable for the Exchange to allow the RFQ to remain open so that the trading crowd may re-quote the market in response to the same contract set forth in the existing RFQ without submitting another RFQ.

The Commission notes that this provision only allows a member to re-quote the market later in the day with respect to the open RFQ from which a trade has not been executed.

The Commission also believes that it is reasonable for the Exchange to allow for FLEX orders to be accepted onto a FLEX limit order book. As noted above, the Specialist in the listed non-FLEX equity or index option, whether or not

⁵⁴ The Exchange notes that although the principles of price/time priority and simultaneous bids/offers at parity of Rule 1014 apply, the enhanced specialist participation of sub-paragraphs (g) (ii) and (iii) are not applicable to FLEX options.

⁵⁵ The Exchange notes that the Options Committee may determine to establish an abbreviated response time for a new RFQ, because the full ten minutes may not be required for pricing determinations.

⁵⁶ See e.g., CBOE Rule 24A.6, which states that a Floor Broker may be given discretion with respect to the number of FLEX contracts to be purchased or sold.

⁵⁷ If the option is not listed on the Exchange, specialist functions may be allocated by the Exchange pursuant to Phlx Rules 500 et seq.

⁵⁸ See Floor Procedure Advice F-2, Time Stamping, Matching and Access to Matched Trades.

⁵⁹ 15 U.S.C. 78f(b)(5).

⁶⁰ 15 U.S.C. 78k-1.

⁶¹ In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

assigned in FLEX options, will maintain a FLEX limit order book. The Commission believes that a FLEX limit order book, maintained by a Specialist, should help to accommodate FLEX options trading.

The Commission notes that the Phlx is the first exchange to create a limit order book for FLEX options. The Commission believes that by establishing both a FLEX and non-FLEX limit order book for the same option classes, the Exchange should monitor the use of the FLEX limit order book to ensure that members are not using the limit order book to trade ahead of non-FLEX limit orders for the same options class. The Commission believes that this concern is minimized because FLEX options should generally have an expiration date at least two days before or after the expiration date for the corresponding non-FLEX option, thus FLEX and non-FLEX option contracts are not fungible.

Additionally, the Commission believes that the Exchange's proposal to provide a minimum right of participation of at least 25% of the trade to Exchange members who initiate Requests for Quotes in respect of FLEX options and indicate an intention to cross or act as principal on the trade, is consistent with the Act. In addition, under Phlx rules, all FLEX options transactions must be in compliance with the priority, parity, and precedence requirements of Section 11 of the Act,⁶² and Rules 11a1-1(T)⁶³ and 11b-1,⁶⁴ promulgated thereunder. These provisions set forth, among other things, the conditions in which members must yield priority to public customers' bids and offers at the same price.

The Commission also believes that the Exchange's proposal to require at least two assigned ROTs, or an assigned specialist and an assigned ROT for each FLEX option class, is consistent with the Act. The Commission notes that the Exchange's rules currently provide a framework that encourages assigned ROTs and specialists, to actively make responsive quotes to provide liquidity in FLEX options. In fact, assigned ROTs and specialists, who respond to an RFQ, must do so with a market of the minimum size in response to the RFQ. Further, assigned ROTs and specialists must provide a market in any FLEX option when requested by a Floor Official. Accordingly, the Commission believes that this requirement should be sufficient to provide quotations in

response to an RFQ and generally accommodate FLEX options trading.

The Commission also believes that the Exchange's proposal to permit FLEX equity options trading on any options-eligible security regardless of whether Non-FLEX equity options overlie that security and trade on the Exchange is reasonable, in that it promotes fair competition among exchanges, consistent with Section 11A of the Act, and will perfect the mechanism of a free and open market and serve to protect investors and the public interest in accordance with Section 6(b)(5) of the Act. The Commission notes that Phlx FLEX equity options must still meet the eligibility requirements and criteria set forth in Phlx Rule 1009.

In addition, the Commission believes that the Exchange's proposal to designate all currently approved Phlx index options as eligible for FLEX index options trading is consistent with the Act. The Commission notes, however, that when submitting a Section 19(b) proposal to list and trade a new non-FLEX index options product, the Exchange must, in the same filing, specifically propose to list and trade the FLEX index options in the same proposed rule change. If the Exchange is not prepared at that time to seek approval for the listing of FLEX options overlying the proposed index, then the Exchange should submit a rule filing pursuant to Section 19(b) of the Act proposing to list FLEX options on that index at an appropriate time in the future.

The Commission believes it is consistent with Section 6(b)(5) of the Act for the Phlx to establish trading hours for FLEX options that begin thirty minutes after the non-FLEX market trading hours, and end at the same time as normal non-FLEX market trading hours. The Commission also believes that because of the nature of the FLEX market, in contrast to the Non-FLEX market, it is reasonable to permit the Exchange, in its discretion, to restrict or expand trading hours for FLEX options, so long as such trading hours occur within the normal options trading hours of the Exchange.⁶⁵

The Commission believes that the Exchange's proposal to restrict exercise prices for calls on FLEX equity options, as described above, reasonably balances the desire of sophisticated portfolio managers and other institutional investors to trade flexible equity options products, with the need to eliminate the potential that the trading of such options could inadvertently impact a tax benefit currently provided to writers of

standardized call options that qualify as QCCs.⁶⁶ In approving this provision, the Commission recognizes that the Exchange will restrict the flexibility of investors in determining an essential term of FLEX equity call options contracts (*i.e.*, the exercise price). Nevertheless, investors will still be able to designate contract terms for exercise style (*i.e.*, American or European) and expiration date.⁶⁷ Based on this and the current tax framework for QCCs, the Commission believes the limitations imposed by the proposal is appropriate and should still provide investors with a more flexible product than one with standardized option terms while protecting investors in the standardized equity call options market.⁶⁸

The Commission also believes that it is reasonable for the Exchange to propose to eliminate position and exercise limits for FLEX equity options on a two-year pilot basis. While the Commission has generally taken a gradual, evolutionary approach toward expansion of position and exercise limits, the Commission is willing to approve the two-year pilot program for FLEX equity options for several reasons. First, the FLEX equity options market is characterized by large, sophisticated institutional investors (or extremely high net worth individuals), who have both the experience and ability to engage in negotiated, customized transactions. For example, with a required minimum size of 250 contracts to open a transaction in a new series, FLEX equity options are designed to appeal to institutional investors, and it is unlikely that many retail investors would be able to engage in options transactions at that size. Second, the Exchange's other rules and provisions governing FLEX equity options will remain applicable. Third, the OCC will serve as the counter-party guarantor in every exchange-traded transaction. Fourth, the proposed elimination of position and exercise limits for FLEX equity options could potentially expand the depth and liquidity of the FLEX equity market without significantly increasing concerns regarding intermarket manipulations or

⁶⁶ The Commission notes that the Exchange must file a proposed rule change with the Commission, pursuant to Section 19(b) of the Act, to withdraw or modify this exercise price policy regarding FLEX equity call options.

⁶⁷ Of course, investors will also be able to designate exercise price for FLEX equity put options and FLEX index call and put options.

⁶⁸ The Commission notes, that OCC, in the approved FLEX equity option 9b-1 ODD supplement, informs investors of the limitation of exercise price intervals when writing FLEX equity call options. See FLEX equity options 9b-1 order, *supra* note 18.

⁶² 15 U.S.C. 78k.

⁶³ 17 CFR 240.11a1-1(T).

⁶⁴ 17 CFR 240.11b-1.

⁶⁵ See *supra* note 52.

disruptions of the options or the underlying securities. Finally, the Exchange's surveillance programs will be applicable to the trading of FLEX equity options and should detect and deter trading abuses arising from the elimination of position and exercise limits.

As described above, the Exchange have adopted important safeguards that will allow them to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if necessary. By monitoring accounts in excess of three times the Non-FLEX equity option position limit in this manner, the Exchange should be provided with the information necessary to determine whether to impose additional margin and/or whether to assess capital charges upon a member organization carrying the account. In addition, this information should allow the Exchange to determine whether a large position could have an undue effect on the underlying market and to take the appropriate action.

Given the size and sophisticated nature of the FLEX equity options market, along with the new reporting and margin requirements, the Commission believes that eliminating position and exercise limits for FLEX equity options for a two-year pilot period should not substantially increase manipulative concerns. Nevertheless, the Commission will be able to assess the effects on the markets of the Exchange's proposals during the two-year pilot period. If problems were to arise during such pilot period, the Commission believes that the enhanced market surveillance of large positions should help the Exchange to take the appropriate action in order to avoid any manipulation or market risk concerns.

Nevertheless, because the Commission has only recently agreed to eliminate position and exercise limits for a derivative product, the Commission cannot rule out the potential for adverse effects on the securities markets for the component securities underlying FLEX equity options. To address this concern, the Commission has approved the proposal for a two-year pilot period. The Exchange will undertake to monitor, among other things, open interest and potential adverse market effects and to report to the Commission on the status of the program no later than eighteen months after the order's date of effectiveness. The reporting of the Exchange's experiences should include, among other things, such information as:

(i) The type of strategies used by FLEX equity options market participants and whether FLEX equity options are being used in lieu of existing standardized equity options;

(ii) the type of market participants using FLEX equity options during the pilot program;

(iii) the average size of the FLEX equity option contract during the pilot program, the size of the largest FLEX equity option contract on any given day during the pilot program, and the size of the largest FLEX equity option held by a single customer/member during the pilot program; and

(iv) any impact on the prices of underlying stocks during the establishment or unwinding of FLEX positions that are greater than three times the standard non-FLEX equity option position limits.⁶⁹

The Commission also believes that it is reasonable for the Exchange to conform its rules to the rules of other options exchanges to reduce from 100 contracts to 25 contracts the minimum value size of closing transactions in and exercises of FLEX equity options. The Commission notes that market participants wanting to execute an opening transaction in a particular series of FLEX equity options will continue to be required to meet the 250 (if no open interest in a particular FLEX series) or 100 (if open interest in a particular FLEX series) minimum contract requirement. The Commission believes that this should help to ensure that transactions in FLEX equity options remain of substantial size and, therefore, the product is geared to an institutional, rather than a retail market.

The Commission also believes that the Phlx's proposal to include certain designated foreign currencies in the list of variable FLEX index option contract terms is a reasonable response by the Exchange to meet the demands of sophisticated portfolio managers and other institutional investors. Additionally, the Commission believes that the Phlx's proposal will help to promote the maintenance of a fair and orderly market because it extends the benefits of a listed exchange market to FLEX index options that trade and settle in certain designated foreign currencies.

The Commission believes that investors should benefit from the additional flexibility by permitting them to designate quotation and settlement terms in various foreign currencies while continuing to ensure adequate investor protection in the trading of these products. The potential risk of settling FLEX options in foreign currencies rather than U.S. dollars is

⁶⁹ For a more complete discussion of the Commission's findings regarding the elimination of FLEX equity options position limits, see FLEX Equity Option Position Limit Approval Order, *supra* note 50.

also disclosed in the ODD pursuant to Rule 9b-1 of the Act.⁷⁰

The Commission also notes that FLEX index options can be constructed with expiration exercise settlement based on the closing values of the component securities, which could potentially result in adverse effects for the markets in these securities.⁷¹ Although the Commission continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Friday helps alleviate stock market volatility,⁷² these market impact concerns are reduced in the case of FLEX options because expiration of these options will not correspond to the normal expiration of Non-FLEX options, stock index futures, and options on stock index futures. In particular, FLEX options, will never expire on any "Expiration Friday." More specifically, the expiration date of a FLEX option may not occur on a day that is on, or within, two business days of the expiration date of a Non-FLEX option. The Commission believes that this should reduce the possibility that the exercise of FLEX options at expiration will cause any additional pressure on the market for underlying securities at the same time that Non-FLEX options expire.

In addition, the proposal would limit the effect on securities markets by addressing the relationship between FLEX index options and QIXs. As proposed, Phlx Rule 1079(d)(1) requires P.M.-settled FLEX options to be aggregated with QIXs that are based on the same index and have the same expiration date. In such a case, the FLEX options would be aggregated two days prior to expiration subject to the position limits for the QIX options on the applicable index. The Commission believes that these rules should help prevent an investor from using FLEX options for the purpose of avoiding the position limits applicable to QIXs.

Nevertheless, because the position limits for both FLEX index options are much higher than those currently existing for outstanding exchange-traded index options (and FLEX equity options have no position limit requirements) and open interest in one or more FLEX option series could grow to significant levels, it is possible that FLEX options might have an impact on the securities markets for the securities underlying FLEX options. The Commission expects the Exchange to

⁷⁰ See Securities Exchange Act Release No. 33582 (February, 1994).

⁷¹ See, e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

⁷² *Id.*

monitor the actual effect of FLEX options once trading commences and take prompt action (including timely communication with the self-regulatory organizations responsible for oversight of trading in the underlying securities) should any unusual market effects develop.

The Exchange represents that FLEX options will allow them to compete with OTC markets and help meet the demand for customized options products by institutional investors. The minimum value sizes for opening transactions in FLEX options are designed to appeal to institutional investors, and it is unlikely that most retail investors would be able to engage in options transactions at that size. Nevertheless, the FLEX equity option minimum size for opening transactions⁷³ is much smaller than that for FLEX index options. The Commission also notes that, in approving the proposal to establish 25 contracts as the minimum contract requirement for closing transactions in, and exercises of, FLEX equity options, adequate surveillance guidelines should be in place to ensure that only sophisticated investors with the necessary financial resources to sustain the possible losses arising from transactions in the requisite FLEX options class size are utilizing this product. The Commission's staff has reviewed Phlx's surveillance program and believes it provides a reasonable framework in which to monitor such investor open interest.

Because of these established minimum contract requirements for both opening and closing transactions in FLEX equity options, the Commission requests that the Exchange monitor its respective comparative levels of institutional and retail investor open interest in FLEX equity options for one year from the commencement of its FLEX equity option trading program. In particular, the Commission requests that the Exchange provide a report to the Commission's Division of Market Regulation describing the nature of investor participation (*i.e.*, retail vs. institutional) in FLEX equity options no later than two months following the one-year anniversary of FLEX equity options trading on the Exchange. If the Exchange determines in the interim that the proposed rule change has resulted in a pattern of retail investor participation in FLEX equity options, it should notify the Commission's Division of Market

Regulation to determine if (1) the minimum contract requirements for opening transactions should be increased from 250 contracts, and/or (2) the minimum contract requirements for closing truncations should be restored to the originally proposed level.

The Commission also notes that effective surveillance guidelines are essential to ensure that the Exchange has the capacity to adequately monitor trading in FLEX options for potential trading abuses. The Commission's staff has reviewed Phlx's surveillance program and believes it provides a reasonable framework in which to monitor the trading of FLEX options on its trading floor and detect as well as deter manipulation activity and other trading abuses.

In order to ensure adequate systems processing capacity to accommodate the additional options listed in accordance with the FLEX options program, OPRA has concluded that the additional traffic generated by FLEX index and equity options traded on the Phlx is within OPRA's capacity.⁷⁴

The Commission finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, this amendment proposes that (1) the RFQ include the size and intention to cross, consistent with the existing procedures of other exchanges; and (2) a specific position limit of 22,000 contracts for the Super Cap Index option be adopted. The Commission believes that the proposed amendment further clarifies the proposal and does not raise any new or unique regulatory issues.

Accordingly, the Commission believes, consistent with Section 6(b)(5) of the Act, that good cause exists, to approve Amendment No. 2 to the proposal on an accelerated basis.

The Commission finds good cause for approving Amendment No. 4 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**.⁷⁵ Specifically, as noted above, the Exchange's proposal to (1) eliminate the application of position and exercise limits to FLEX equity options for a two-year pilot period; and (2) reduce the minimum size applicable to a Request-for-Quote for a closing transaction in already-opened FLEX equity options from 100 to 25 contracts, are identical to proposals by other options exchanges that were recently

approved by the Commission. Therefore, the Commission believes that the proposal raises no new regulatory issues.

Further, the Commission believes that other changes incorporated into Amendment No. 4, including, proposals to: (1) amend the proposal rule change to refer consistently to "FLEX index and equity options" (as opposed to index FLEX options); (2) correct the text of proposed Rule 1079(b)(6) regarding the crossing procedure to reflect that the crossing intention has already been announced as part of the RFQ, as amended by Amendment No. 2; and (3) amend proposed Rule 1079(a)(1) to clearly state that any options-eligible security pursuant to Rule 1009 to eligible to underlie FLEX equity options trading. The Commission also believes that these amendments do not raise any new regulatory issues.

Accordingly, the Commission believes, consistent with Section 6(b)(5) of the Act, that good cause exists, to approve Amendment No. 4 to the proposal on an accelerated basis.

The Commission finds good cause for approving Amendment No. 5 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, as noted above, the Exchange's proposed amendment clarifies: (1) the parity and priority principles for FLEX options transactions; and (2) that each assigned ROT or assigned Specialist is not required to respond with a quote in every instance, unless requested by a Floor Official. These provisions are substantially similar to those of other options exchanges that were recently approved by the Commission. Therefore, the Commission believes that the proposal raises no new regulatory issues.

Accordingly, the Commission believes, consistent with Section 6(b)(5) of the Act, that good cause exists, to approve Amendment No. 5 to the proposal on an accelerated basis.

Interested persons are invited to submit written date, views and arguments concerning Amendment Nos. 2, 4 and 5 to the proposed rule change. 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 this 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

⁷³The minimum size for an opening transaction in FLEX equity options is 250 contracts for any FLEX series in which there is no open interest, and 100 contracts in any currently opened FLEX series.

⁷⁴ See Letter from Joseph P. Corrigan, Executive Director, OPRA, to Sharon Lawson, Senior Special Counsel, OMS, Market Regulation, Commission, dated October 20, 1997. ("OPRA Capacity Letter").

⁷⁵ As noted *supra* in note 8, Amendment No. 4 supersedes Amendment No. 3, in its entirety.

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 will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to SR-Phlx-96-38 and should be submitted by February 13, 1998.

V. Conclusion

For the reasons discussed above; the Commission finds that the proposal is consistent with the Act and Sections 6 and 11A of the Act, in particular. In addition, the Commission has previously concluded pursuant to Rule 9b-1 under the Act, that FLEX options, including FLEX equity options and FLEX index options, and FLEX index options traded and settled in certain designated foreign currencies, are standardized options for purposes of the options disclosure framework established under Rule 9b-1 of the Act.⁷⁶ Apart from the flexibility with respect to strike prices, expiration dates, exercise styles, and settlement (for FLEX index options), all of the other terms of FLEX options are standardized pursuant to OCC and Phlx rules.

Standardized terms include matters such as exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions on exercise under OCC rules, margin requirements, and other matters pertaining to the rights and obligations of holders and writers.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁷⁷ that the proposal (File No. SR-Phlx-96-38), as amended, including Amendment Nos. 2, 4 and 5 on an accelerated basis, is approved. In addition, the portion of the proposal eliminating FLEX equity options position and exercise limits is approved on a pilot basis until January 14, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁷⁸

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39552; File No. SR-Phlx-97-55]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Establishing an Enhanced Parity Split Pilot Program for Specialists in Foreign Currency Options Effective Until December 31, 1998

January 14, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on December 1, 1997, the Philadelphia Stock Exchange, Inc. ("Phlx" 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 Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange seeks to revise Exchange Rule 1014(h) to establish an enhanced parity split pilot program ("Pilot Program") for its foreign currency option ("FCO") specialists effective until December 31, 1998.

The text of the proposed rule change is available at the Office of the Secretary, the Exchange, and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange previously provided and enhanced parity split to the

specialist dealing in dollar denominated delivery German Mark ("3D German Mark") options.² The enhanced parity split gave the specialist 50% of the first 500 contracts of any trade in 3D German Mark options. The Exchange eliminated the enhanced parity split earlier this year because the specialist in 3D German Mark options and other traders of the product found it to be of little benefit.³ At the time the enhanced parity split was eliminated, the Exchange informed the Commission that it would continue to study the potential use of an enhanced parity split for all FCO specialists on a broader basis. This proposed rule change sets forth the Exchange's plan for the expanded use of the enhanced parity split in FCOs.

The Exchange seeks to implement an enhanced parity split procedure similar to the one currently applied to transactions in equity and index options at the Exchange.⁴ Under the Pilot Program, however, the application of the proposed FCO enhanced parity split would be more widespread, and the enhanced parity split would be available to all FCO specialists assigned to FCO products.⁵ The Pilot Program would be in effect until December 31, 1998.

The enhanced parity split would apply to the first 500 contracts in a FCO transaction in a FCO transaction. When the enhanced parity split is applied, the

²The enhanced parity split for the specialist in 3D German Mark options was first approved on December 29, 1994. See Securities Exchange Act Release No. 35177 (Dec. 29, 1994), 60 FR 2419 (Jan. 9, 1995). 3D German Mark options are cash-settled, European-style, cash/spot foreign currency option contracts on the German Mark that trade in one-week and two-week expirations.

³The enhanced parity split was eliminated as of September 8, 1997. See Securities Exchange Act Release No. 39030 (Sept. 8, 1997), 62 FR 48332 (Sept. 15, 1997). The sole specialist firm trading 3D German Mark options indicated that the enhanced parity split was not particularly useful and that it did not generally take advantage of it. Furthermore, the Exchange represented that the order size in 3D German Mark options generally was not large enough to trigger the application of the enhanced parity split (*i.e.*, such orders represented less than 100 contracts).

⁴The Exchange recently amended its enhanced parity split pilot program for equity and index option specialists to expand its application. As a result of the amendment, all index options and all newly listed equity options receive the enhanced parity split. However, only 50% of those equity options not considered "newly listed" are eligible to receive the enhanced parity split. In addition, specialists are now permitted to revise the list of eligible equity options on a quarterly basis, rather than an annual basis. See Securities Exchange Act Release No. 39401 (Dec. 4, 1997), 62 FR 65300 (Dec. 11, 1997).

⁵It should be noted that because FCOs on the Italian Lira and the Spanish Peseta are traded as customized options, there are no specialists assigned to those products. For simplicity and clarity, all further references to FCOs shall not include these two products.

⁷⁶ 17 CFR 240.9b-1. See *supra* note 9.

⁷⁷ 15 U.S.C. 78s(b)(2).

⁷⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).