

structured products, the Exchange will closely monitor activity in the Notes to identify and deter any potential improper trading activity in the Notes.

## 2. Basis

The proposed rule change is consistent with Section 6(b)<sup>9</sup> of the Act in general and furthers the objectives of Section 6(b)(5)<sup>10</sup> in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of change, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition.

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

No written comments were solicited or received with respect to the proposed rule change.

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

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)<sup>11</sup> and Rule 19b-4(e)(6)<sup>12</sup> of the Act. The proposed rule change does not significantly affect the protection of investors or the public interest, does not impose any significant burden on competition; and does not become operative prior to 30 days after the date the proposed rule change was filed with the Commission.

Rule 19b-4(e)(6) also provides that the SRO provide the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing the proposed rule change, or such shorter time as designated by the Commission. The Amex requested that the Commission waive the notification period in order to expedite the listing and trading of term notes linked to Select Sector SPDRs<sup>SM</sup>. The Commission finds good cause to waive the notification period because it

previously reviewed and approved the composition and maintenance of the nine Select Sector SPDRs<sup>SM</sup> underlying the term notes.<sup>13</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the purposes of the Act.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to file number SR-Amex-98-48 and should be submitted by February 18, 1999.

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

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 99-2003 Filed 1-27-99; 8:45 am]

BILLING CODE 8010-01-M

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40951; File No. SR-CBOE-98-33]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Exercise Advice Procedures

January 15, 1999.

## I. Introduction

On July 27, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities Exchange Commission ("SEC" or "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. The Exchange proposes to clarify certain existing exercise procedures for cash-settled and noncash-settled options and to provide that the failure to submit an exercise advice in a timely manner will be designated as a minor rule violation subject to summary fines set forth in CBOE Rule 17.50. Amendment No. 1 was submitted to the Commission on November 3, 1998.<sup>3</sup> The proposed rule change was published for comment in the **Federal Register** on November 16, 1998.<sup>4</sup> The Commission received no comments on the proposal. This order approves the proposal, as amended.

## II. Description of the Proposal

### *Restrictions on the Exercise of Cash-Settled Index Options*

Currently, a cash-settled index option cannot be exercised during a trading delay, halt or suspension. This policy does not apply if the trading delay, halt, or suspension occurs on the last business day prior to expiration or if the President of the Exchange or his designee determines otherwise. The Exchange proposes to amend CBOE Rule 11.1.05 to codify this policy.<sup>5</sup> In

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

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

<sup>3</sup> Letter from Arthur B. Reinstein, Assistant General Counsel, CBOE, to Kelly McCormick, Attorney, Division of Market Regulation, SEC, dated October 27, 1998 ("Amendment No. 1"). Amendment No. 1 clarifies the Business Conduct Committee's authority to impose sanctions under proposed rules 17.50(c)(2) and (d)(2); makes technical corrections to the proposed rule language; clarifies amendments to proposed rules 11.1.05 and 11.1.07; and elaborates on the statutory basis for the proposed rule change.

<sup>4</sup> Exchange Act Release No. 40645 (November 6, 1998) 63 FR 63761 (November 16, 1998).

<sup>5</sup> The Exchange note that the restriction of the exercise of cash-settled index options is currently reflected in Exchange Regulatory Circular RG-91-11.

<sup>9</sup> 15 U.S.C. 78f.

<sup>10</sup> 15 U.S.C. 78f(b)(5).

<sup>11</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>12</sup> 17 CFR 240.19b-4(e)(6).

<sup>13</sup> Supra note 3.

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

addition, the Exchange proposes to allow processing of an exercised cash-settled index option during a trading delay, halt, or suspension if it can be documented that the decision to exercise the option was made during an allowable time frame, before the delay, halt, or suspension. The Exchange proposes to codify this policy in proposed CBOE Rule 4.16(b), which is the general rule regarding exercise restrictions.<sup>6</sup>

#### *Exercise Notice Procedures for Cash-Settled Index Options*

CBOE Rule 11.1.03 currently requires members to notify the Exchange of certain exercise decisions concerning cash-settled index options and sets forth procedures for providing such notification. The Exchange proposes to amend CBOE Rule 11.1.03 that the rule only applies to American-style, cash-settled index options and does not apply to European-style, cash settled index options.<sup>7</sup>

#### *Exercise Notices Inconsistent with Just and Equitable Principles of Trade*

Currently, CBOE Rule 11.1.07 states that submitting or preparing an exercise instruction after the exercise cutoff time for any expiring option on the basis of material information released after the cutoff time is inconsistent with just and equitable principles of trade. CBOE Rule 11.1.07 applies to expiring noncash-settled equity options. The Exchange has also considered preparing or submitting an exercise advice or advice cancel after the applicable deadline for any non-expiring American-style, cash-settled index option based on material information released after the deadline to be inconsistent with just and equitable principles of trade.

The Exchange believes this policy would be more effectively communicated to members if it is moved to proposed Rule 11.1.03(e), for American-style, cash-settled index options and repeated in proposed CBOE Rule 11.1.06(f) for noncash-settled equity options. By adding these new subdivisions, the Exchange believes members will be made aware of the policy without having to refer to other interpretations of the Rule.

Therefore, the Exchange proposes to add new paragraph (e) to Rule 11.1.03

to specify for non-expiring American-style, cash-settled index options that preparing or submitting an exercise advice or advice cancel after the applicable deadline on the basis of material information released after the deadline, in addition to constituting a violation of Rule 11.1, is an activity inconsistent with just and equitable principles of trade. Moreover, the Exchange proposes to add new paragraph (f) to CBOE Rule 11.1.06 to specify that preparing or submitting an exercise instruction, contrary exercise advice, or advice cancel after 4:30 p.m. Chicago Time on the basis of material information released after such time, in addition to constituting a violation of CBOE Rule 11.1, is an activity inconsistent with just and equitable principles of trade. Accordingly, the general provision currently found in CBOE Rule 11.1.07 will no longer be necessary and will be deleted.

#### *Options Not Subject to Exercise by Exception*

The Exchange proposes to clarify the requirements in CBOE Rule 11.1.06(c) which applies to exercise decisions and instructions for noncash-settled equity options that are not subject to the exercise by exception provisions of the Options Clearing Corporation's Rule 805. Proposed CBOE Rule 11.1.06(c) will clarify that a member must deliver to the Exchange, no later than 4:30 p.m. Chicago Time, each exercise instruction prepared, submitted, or accepted by the member for all noncash-settled equity options that are not subject to the automatic exercise procedures of exercise by exception. Proposed CBOE Rule 11.1.06(d) clarifies that a member is excused from compliance with the exercise instruction requirements if one of the exceptions set forth in CBOE Rule 11.1(b) applies and the member complies with Interpretation .01 of the Rule. Accordingly, the Exchange proposes to delete paragraphs (c)-(e) of CBOE Rule 11.1.06 and replace them with new paragraphs (c) and (d).

#### *Other Clarifications*

The Exchange also proposes to revise CBOE Rule 11.1.03(c) concerning the preparation of exercise advices before the purchase of American-style, cash-settled index option contracts to mirror the same provision that applies to noncash-settled equity options in CBOE Rule 11.1(d). In addition, the Exchange proposes to amend CBOE Rule 11.1 to accurately reference the definitions of preparation, submission and acceptance of exercise instructions. As amended, the Exchange believes the proposed rule reflects the different sources of exercise

instructions (*i.e.*, Clearing Members prepare exercise instructions for proprietary accounts, members submit exercise instructions to Clearing Members, and members accept exercise instructions from customer accounts). Finally, the Exchange has corrected references to defined terms. For example, references to "Member" or "Member Organization" have been corrected to refer to the term member as defined in Section 1.1 of the Exchange Constitution.

#### *Summary Fines for Failure to Submit an Exercise Advice*

The Exchange proposes to make the failure to submit a contrary exercise advice, advice cancel, or exercise instruction in a timely manner pursuant to CBOE Rule 11.1.06, relating to the exercise or nonexercise of a noncash-settled equity option, a minor rule violation subject to the procedures and summary fine provisions of CBOE Rule 17.50. The Exchange proposes to add new paragraph (8) to CBOE Rule 17.50(g) to provide that any member that fails to follow the advice procedures in CBOE Rule 11.1.06 will be subject to summary fines specified in CBOE Rule 17.50. A member will receive a Letter of Information for the first infraction, in any twelve-month period. A member will receive a Letter of Caution for a second infraction, and for any subsequent infractions a member will receive a \$500 fine.

Members will be able to contest a summary fine decision for violation of proposed CBOE Rule 17.50(g)(8). CBOE Rule 17.50(c)(1), which permits members to seek review by the Business Conduct Committee ("BCC"), has been amended to provide review of fines imposed under new paragraph (g)(8).

#### *Calculation of Summary Fines for Failure to Submit Accurate Trade Information*

CBOE Rules 17.50(g)(4)(b) and (5)(b) provide for the escalation of total fines for repeated violations of CBOE Rule 6.51. CBOE Rule 6.51 sets forth the reporting duties of members. The Exchange proposes to amend paragraphs (4)(b) and (5)(b) regarding the calculation of the total fine imposed on a member after 2 fines for failing to submit or report accurate trade information in any 18-month period. If a member incurs two fines under CBOE Rule 17.50(g)(4) or, similarly CBOE Rule 17.50(g)(5), in any 18-month period, any subsequent fine will be calculated by adding the amount of the fine assessed

<sup>6</sup> Proposed CBOE Rule 11.1.05 will also cross reference proposed CBOE Rule 4.16(b).

<sup>7</sup> The proposed rule does not apply to European-style options because European-style options cannot be exercised early. Moreover, their value is fixed on their expiration day and cannot be changed or effected by subsequent news. Therefore, the Exchange does not require exercise advices to be filed.

for the current violation to the amount of the next most recently incurred fine.<sup>8</sup>

The Exchange also proposes to amend CBOE Rule 17.50.03(a) to change from the fifth day of the month to the tenth day of the month the date by which the Exchange shall attempt to serve members who incur fines under CBOE Rule 17.50(g)(4) or (g)(5). The proposed rule change also amends the day by which a member may request verification of the fine from the Exchange. The member will now have to make such a request by the twenty-fifth of the month instead of the twentieth of the month, as currently required. The Exchange believes these changes will provide more time to process the fines at the beginning of the month while preserving the current time period by which a member may request verification of the fines.

#### *Exchange Discretion to Bring Disciplinary Action*

The Exchange is proposing to modify the summary fine appeal provisions found in CBOE Rule 17.50(c)(2) and (d)(2). The Exchange proposes to clarify the BCC's and the Appeals Committee's authority to impose sanctions in an appeal of a minor rule violation. The appellate panel must determine that the conduct serving as the basis for the action under review is in fact a violation of an Exchange rule before a sanction may be imposed. The BCC and the Appeals Committee, however, may only review the alleged conduct to determine if the conduct violates the rule charged and appealed. If the alleged conduct would constitute a violation, the BCC or the Appeals Committee could determine that the conduct at issue did not rise to the level that would trigger a summary fine but was, nonetheless, in violation of the Exchange Rule alleged to have been violated. In such a case, the BCC or the Appeals Committee could impose a disciplinary sanction for the violating conduct as part of its decision concerning the summary fine appeal.

The Exchange also proposes to modify CBOE Rule 17.50(f) the conform it to a

<sup>8</sup> The Exchange provided the following example: In January, Member XYZ incurs a fine of \$100 under CBOE Rule 17.50(g)(4) for violation of CBOE Rule 6.51 (based on the percentage of times that the member submitted inaccurate or no transaction times). In February, Member XYZ incurs a second fine under CBOE Rule 17.50(g)(4) and the appropriate fine is deemed to be \$250. In March, Member XYZ incurs a third fine for \$100 and, pursuant to CBOE Rule 17.50(g)(4)(b), must pay a total fine of \$350, which is calculated by adding the third fine incurred (\$100) to the next most recently incurred fine (\$250). In April, Member XYZ incurs a fourth fine of \$250 and, pursuant to CBOE Rule 17.50(g)(4)(b), must pay a total of \$600 calculated by adding the fourth fine (\$250) to the total fine most recently incurred (\$350).

rule of the Chicago Stock Exchange.<sup>9</sup> Proposed CBOE Rule 17.50(f) has been amended to clarify that the Exchange has the discretion not to issue a summary fine under CBOE Rule 17.50 in appropriate circumstances such as when extenuating circumstances exist or when no remedial purpose would be served by the issuance of the fine. In addition, the Exchange would have the discretion to commence a formal disciplinary proceeding under CBOE Rule 17.2 whenever the Exchange determines that a rule violation is not minor in nature.

The Exchange proposes to implement the proposed rule change within 45 days after its approval by the Commission. The Exchange notes the reason for the time interval is to give the Exchange the opportunity to inform members in the Exchange's Regulatory Bulletin before the changes are put into effect. The Exchange proposes to publish the effective date in the Exchange's Regulatory Bulletin and will notify the Commission of the effective date by letter.

### **III. Discussion**

After careful review, 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.<sup>10</sup> In particular, the Commission finds that the proposed rule change is consistent with the requirements of Sections 6(b)(5) and 6(b)(6)<sup>11</sup> of the Act.

Section 6(b)(5) of the Act<sup>12</sup> provides, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, to foster cooperation and coordination with persons engaged in regulating, clearing, and settling securities transactions, and to protect investors and the public interest. The proposed rule change clarifies and codifies options exercise procedures and the disciplinary procedures for certain violations. By clarifying and codifying these procedures, the Exchange provides notice of Exchange rules, which should discourage fraudulent and manipulative acts and practices and facilitate Exchange

members' compliance with exercise procedures.

The proposed rule change further clarifies and classifies the exercise procedures for both cash-settle index options and noncash-settled equity options. The proposed rule change further clarifies the appropriate rules for each type of product by expressly stating the procedures and policies applicable to each type of product under independent subsections. For example, the exercise rules for American-style cash-settled index options, found in CBOE Rule 11.1.03(d), have been amended to reflect the policy that an exercise advice may not be prepared before the purchase of the option contract. This amendment mirrors the same provision found in CBOE Rule 11.1(d), which applies to noncash-settled equity options. By further grouping these rules together based upon the type of product, members will have a clearer picture of applicable exercise procedures, which should prevent fraudulent and manipulative acts and practices and thereby foster investor protection.

The mandates of Section 6(b)(5) are also furthered because the proposed rule change clarifies that submitting or preparing an exercise instruction for either non-expiring American-style, cash-settled index options or expiring noncash settled equity options on the basis of material information released after the cutoff time is inconsistent with just and equitable principles of trade. This policy will now be found in proposed CBOE Rule 11.1.03(e), for American-style, cash-settled index options and repeated in proposed CBOE Rule 11.1.06(f). The policy ensures that options are exercised justly and equitably by preventing the improper use of material information.

The Commission also finds that the proposed rule change is consistent with the requirements of Section 6(b)(6) of the Act,<sup>13</sup> which requires that members shall be appropriately disciplined for violation of the provisions of the Act, the rules and regulations thereunder, or the rules of the exchange. The Exchange proposes to make the failure to submit a contrary exercise advice, advice cancel, or exercise instruction in a timely manner pursuant to CBOE Rule 11.1.06, relating to the exercise or nonexercise of a noncash-settled equity option, a minor rule violation subject to the procedures and summary fine provisions of CBOE Rule 17.50. By making the violation of CBOE Rule 11.1.06 a minor rule violation, members will be appropriately disciplined in a

<sup>9</sup> See Exchange Act Release No. 37255 (May 30, 1996) 61 FR 28918 (June 6, 1996) (approving Chicago Stock Exchange Article XII, Rule 9).

<sup>10</sup> In reviewing this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f(b)(5); 15 U.S.C. 78f(b)(6)

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78f(b)(6).

timely manner, which should quickly prevent future violations. Members should not be prejudiced by the rule because their right of review by the BCC remains intact.

The proposed CBOE Rules 17.50(c)(2) and (d)(2) are also consistent with the disciplinary requirements of Section 6(b)(6). These provisions are amended to reflect the BCC's and the Appeals Committee's authority to review conduct and impose sanctions during a summary fine appeal. If the BCC or the Appeals Committee determines that a member's conduct is in violation of the Exchange rule alleged to have been violated, either appellate panel has the authority to impose sanctions even if the conduct does not rise to the level of triggering a summary fine. The Exchange explained that it believes these appellate panels have the authority to impose alternate sanctions even if the conduct does not reach the level to trigger a summary fine.<sup>14</sup> The BCC and the Appeals Committee are, however, limited to reviewing the alleged conduct as it refers to the rule originally charged and appealed and to imposing sanctions for violations found of such rule. The Commission believes that these rules are designed to appropriately and fairly discipline members of violations of Exchange rules. The proposed rule change should ensure that members who repeatedly commit minor violations will not be able to avoid discipline. Moreover, the proposed rule protects members by limiting the appellate panel to review the member's conduct as it relates to violations of the rule originally charged and appealed.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>15</sup> that the proposed rule change (SR-CBOE-98-33) is approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 99-2001 Filed 1-27-99; 8:45 am]

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<sup>14</sup> See CBOE Rule 17.50(f), which provides that the Exchange may, whenever it determines that any violation is not minor in nature, proceed under CBOE Rule 17.2.

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

<sup>16</sup> 17 CFR 200.30-3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40957; File No. SR-CBOE-98-53]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. To Amend the Firm Quote Requirement

January 20, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on December 15, 1998, the Chicago Board Options Exchange, Inc. ("CBOE" 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 CBOE. 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 proposes to amend its firm quote rule, Rule 8.51, and Interpretation and Policy .04 to Rule 6.8, to amend the firm quote requirement so that it is equal to the RAES contract limit applicable to that class of options. Rule 8.51 also will allow the appropriate Floor Procedure Committee ("FPC") to establish a different requirement for a particular class of options that is no less than the RAES contract limit and no more than fifty (50) contracts to enable the FPC to deal with specific circumstances of trading in a particular options class. For classes or series that are not traded on RAES, the appropriate FPC would be able to establish a firm quote requirement of between ten (10) and fifty (50) contracts. The text of the proposed rule change is available at the Office of the Secretary, CBOE 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 CBOE 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 CBOE 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. Basis

The Exchange proposes to amend its firm quote requirement to allow the appropriate FPC to establish the requirement for each particular class of options. Generally, the firm quote requirement will be equal to the RAES contract limit applicable to that class of options. The firm quote requirement will apply at all times, except during a trading rotation, and obligates a trading crowd to sell (buy) the established number of contracts at the offer (bid) which is displayed when a buy (sell) customer order reaches the trading station where the particular option class is located for trading. Currently, paragraph (a)(2) of Rule 8.51 requires trading crowds to buy (sell) at least ten (10) contracts under these circumstances.

Because RAES is essentially a form of electronic firm quote, the Exchange believes that in most cases, the firm quote requirement should be no less than the RAES contract limit for a particular options class. In fact, in deciding to raise the firm quote requirement, the Exchange noted that the appropriate FPC responsible for setting the contract limit for RAES in particular option classes recently increased the RAES maximum contract size, such that in most cases the RAES contract limit is now higher than the firm quote requirement.<sup>2</sup> Additionally, the CBOE proposes to allow the appropriate FPC, in its discretion, to establish a different firm quote requirement for a particular class of options that is no less than the RAES contract limit and no more than fifty (50) contracts. This provision would enable the appropriate FPC to deal with the specific circumstances of trading in a particular option class. For classes or series that are not traded on RAES, the appropriate FPC would be able to establish a firm quote requirement of between ten (10) and fifty (50) contracts.<sup>3</sup>

<sup>2</sup> See Regulatory Circulars RG98-102, RG98-117, RG98-119.

<sup>3</sup> The new firm quote requirement will remain in effect for that options class indefinitely or until the FPC changes it. The FPC meets once every two weeks. The discretion given by the proposed rule change is intended to enable the FPC to respond to general trading trends in a given options class. Phone call between Timothy Thompson, Director, Regulatory Affairs, Legal Department, CBOE, Sonia

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