

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### 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. 20549-0609. 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 Room. Copies of the filing will also be available for inspection and copying at the principal offices of the NASD. All submissions should refer to File No. SR-NASD-99-35 and should be submitted by October 1, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41824; File No. SR-PCX-99-24]

### Self-Regulatory Organizations; Notice of Filing of Amendment No. 2 and Order Granting Partial Accelerated Approval to a Proposed Rule Change by the Pacific Exchange, Inc. Relating to Automated Opening Rotations

September 1, 1999.

#### I. Introduction

On July 13, 1999, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") 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 related to automated opening rotations ("AOR"s). On August 4, 1999, the PCX filed with the Commission Amendment No. 1 to the proposal.<sup>3</sup> Notice of the proposed rule change appeared in the **Federal Register** on August 30, 1999.<sup>4</sup> On September 1, 1999, the PCX filed Amendment No. 2 to the proposal.<sup>5</sup> The Commission is publishing this notice to solicit comments on Amendment No. 2. In addition, for the reasons discussed below, the Commission has determined to grant accelerated approval of PCX's request in Amendment No. 2 to implement automated opening rotations for 16 issues on a thirty day pilot basis.

#### II. Description of the Proposal

##### A. Introduction

The Exchange is proposing to adopt a new procedure to facilitate trading of option contracts during the opening rotation.<sup>6</sup> Opening rotations are held promptly following the opening of the underlying security on the principal market where it is traded.<sup>7</sup> Opening rotations are conducted by an Order Book Official ("OBO"), who is an Exchange employee.<sup>8</sup> The PCX rules on opening rotations apply to both index and equity options contracts.<sup>9</sup>

In its initial filing, as amended by Amendment No. 1, the PCX proposed a new process that would allow the Exchange to conduct AORs. The Exchange proposed a procedure to allow the OBO to establish electronically a single price opening for executing eligible market and marketable limit orders in the POETS system. In the event of an imbalance, any remaining orders in the system that are eligible to be executed will be assigned to market makers participating on the Auto-Ex System. The new process involves three basic steps: first, the markets are

established; second, the opening rotation is automatically processed for the majority of series; and finally, any series with manual orders or compilation is opened manually, *i.e.*, pursuant to the current procedures for opening rotations.

More specifically, under the new AOR process, opening rotations on the PCX will occur in the following manner: Prior to the opening, the OBO will determine whether there are any orders in the trading crowd to be executed at the opening. Once the underlying security has opened, the OBO will request from the trading crowd bids and offers in the specific option issue. The trading crowd may determine that the posted bids and offers are accurate, or alternatively, may request by public outcry that certain quotes be modified.<sup>10</sup> Once the bid and asking price in each series has been ascertained, the OBO and AOR system will identify all series that are eligible for the AOR and that can be opened immediately, and will also identify all series that are not eligible for the AOR. Those that are not eligible for the AOR must be opened manually.<sup>11</sup>

##### B. Amendment No. 2

In Amendment No. 2, the PCX requests that the Commission grant accelerated approval of a thirty day pilot program ("Pilot") that would allow the Exchange to use automated openings for 16 issues during the pilot period. The 16 issues are Microsoft Corp. (MSQ), Compaq Computer Corp. (CPQ), Sun Microsystems, Inc. (SUQ), Applied Materials (AMAT), 3Com Corp. (THQ), Advanced Micro Devices (AMD), Tellabs, Inc. (TLAB), Schering-Plough Corp. (SGP), McKesson HBOC, Inc. (MCK), ALZA Corp. (AZA), R&B Falcon Corp. (FLC), First Union Corp. (FTU), NIKE, Inc. (Class B) (NKE), Newbridge Networks Corp. (NN), Data General

<sup>3</sup> In Amendment No. 1, the Exchange further clarifies the operation of automated openings, provides rule text related to the new procedures, and justifies its request for accelerated approval. See letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation ("Division"), SEC, dated August 3, 1999 ("Amendment No. 1").

<sup>4</sup> See Securities Exchange Act Release No. 41774 (August 20, 1999), 64 FR 47210.

<sup>5</sup> In Amendment No. 2, the Exchange provides additional details about the operation of automated openings and proposes limited use of such openings for certain issues on a pilot basis. See letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Richard Strasser, Assistant Director, Division, SEC, dated September 1, 1999 ("Amendment No. 2").

<sup>6</sup> The Exchange intends to continue to employ the current (manual) procedures for closing rotations.

<sup>7</sup> See PCX Rule 6.64, Comment .01(a).

<sup>8</sup> See PCX Rules 6.51 and 6.64.

<sup>9</sup> See PCX Rule 7.10.

<sup>10</sup> Prior to an automated opening, the members of the trading crowd must establish a bid and offer for each series in a given issue. This occurs basically as follows: The OBO will first display a bid price and an offering price for a particular series. (These prices will have been established either by the Auto-Quote feature of POETS or by a manual process, *i.e.*, a member or members of the trading crowd will vocalize bids and offers that a Market Quote Terminal Operator will enter into the system and display on the overhead screen.) The OBO will then ask the crowd if the displayed prices are "all right" (or other words to that effect). There will then be a short window period when the displayed prices may be adjusted. While the trading crowd is establishing the market, any member may vocalize a bid or offer that improves the market, and the OBO will be required to update the market accordingly. See Amendment No. 1.

<sup>11</sup> For a more detailed description of the current and proposed processes, see Securities Exchange Act Release No. 41774 (August 20, 1999), 64 FR 47210 (August 30, 1999).

<sup>6</sup> 17 CFR 200.30-3(a)(12).

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

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

Corp. (DGN), and Baker Hughes Inc. (BHI). These issues, previously traded only on the PCX, now will be approved for trading on other options exchanges.

Amendment No. 2 also further details how the proposed automated openings would work during the Pilot period and beyond. First, the Exchange clarifies when manual openings will be held. Generally, a series will not be eligible for an AOR if one or more members of the trading crowd has reasonably requested a manual opening rotation in that series. The Exchange anticipates that such requests will fall into two general categories. The first category involves mergers and takeovers. The second category would cover system problems or system limitations. For example, the POETS system may be unable to generate an accurate market because it is unable to take into account the fact that a takeover will occur on the following day, and as such, the system is unable to factor in the correct model. In these situations, the series will be opened manually.

As for the provision allowing manual openings when imbalance thresholds are exceeded, the Exchange proposes to implement this provision in the following manner. Initially, each option issue will have a minimum imbalance threshold of 20 contracts. However, a Lead Market Maker in an issue may increase the imbalance threshold in that issue to a number greater than 20, but not exceeding 999 contracts (due to system constraints). The decision to change the imbalance threshold will be made pursuant to proposed Rule 6.64(b)(2)(D). Language in subsection D was previously in subsection C. The modified rule text follows. Proposed text is italicized.

*(C) Series for which one or more members of the trading crowd has reasonably requested that a manual opening rotation be conducted. Two Floor Officials may deny member requests for manual opening rotations in the absence of reasonable justification for doing so.*

*(D) Series in which the "imbalance threshold" has been exceeded. Prior to the opening, the OBO, in conjunction with the Lead Market Maker in the issue, will set for each option issue a number of contracts that constitutes an imbalance threshold, i.e., a specific number of option contracts to buy in excess of the number of contracts to sell or a specific number of contracts to sell in excess of the number of contracts to buy. The POETS system will not automatically open any series with an imbalance exceeding the threshold for that issue.*

Second, the Exchange amends the proposed rule text to explicitly provide for the manual accommodation of non-bookable orders when automated openings occur. The text of additional subsection, PCX Rule 6.64(b)(4), follows. New text is italicized.

*(4) Manual Accommodations of Non-Bookable Orders. If a non-bookable order is represented in the trading crowd and disclosed to the Order Book Official prior to the opening rotation, and if the order is either a market order or a limit order with a limit price equal to the opening price of the particular series, then that order will be entitled to an execution immediately following the opening of that series as follows:*

*(A) If the order is a market order or limit order for a public customer, the order will be filled in its entire size by the Market Makers in the trading crowd (assuming that any contingency accompanying the order is satisfied).*

*(B) If the order is a limit order for a broker-dealer, the order will be entitled to be filled up to a number of contracts equal to a pro rata share of the number of contracts that the Auto-Ex system assigns to the Market Makers pursuant to subsection (3), above. If a broker is holding more than one order to trade at the same limit price, then that broker is limited to no more than one pro rata share of the number of contracts that the Auto-Ex System assigns to the Market Makers.*

### III. Discussion

The Commission finds that the proposed rule change relating to the establishment of a Pilot for a 30-day period is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>12</sup> Specifically, the Commission believes the Pilot is consistent with the Section 6(b)(5)<sup>13</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers. The proposed rule change represents an effort to facilitate the execution of orders at the opening by providing market-makers with a means of establishing electronically a single opening price. By facilitating an expedited opening of options series

<sup>12</sup> In approving Amendment No. 2, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

included in the Pilot, AOR should remove an impediment to and help perfect the mechanism of a free and open market consistent with the Exchange's responsibilities under Section 6 of the Act.<sup>14</sup> Moreover, by integrating features into AOR, such as the crossing of customer orders, and by providing procedures for handling non-bookable orders in the opening process, the Commission believes that the proposal should promote fair participation in AOR by all market participants.

The Commission finds good cause for approving the Pilot prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. The Commission notes that the Pilot will only be for a limited duration and for a limited number of issues. Thus, the Commission believes that accelerated approval of the Pilot will enable the Commission and the Exchange to gain experience with AOR before the Commission considers permanent approval of the Pilot.<sup>15</sup>

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. 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 Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCX. All

<sup>14</sup> 15 U.S.C. 78f.

<sup>15</sup> The Commission notes the issues selected for the Pilot are newly introduced for trading on more than one exchange. ROS, an electronic opening system for the Chicago Board Options Exchange, Inc., has already received Commission approval. The Commission expects the PCX to report back on if and how the existence of automatic opening systems at multiple exchanges for newly multiply listed options affects the efficiency of trading and competition among exchanges.

Approval of the 30-day Pilot period should not be interpreted as suggesting that the Commission is predisposed to approving the proposal on a permanent basis or that the Commission is predisposed to extending the Pilot to all issues.

submissions should refer to File No. SR-PCX-99-24 and should be submitted by October 1, 1999.

## V. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>16</sup> that the Pilot program proposed in Amendment No. 2 to SR-PCX-99-24 be and hereby is approved on an accelerated basis to expire October 1, 1999.<sup>17</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41823; File No. SR-PCX-99-04]

### Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 4 by the Pacific Exchange, Inc. Relating to the Maximum Size of Option Orders That May Be Executed Automatically

September 1, 1999.

## I. Introduction

On February 10, 1999, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and 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 amending its rules on the automatic execution of options orders to increase the maximum number of contracts that may be designated for automatic execution on an issue-by-issue basis. On February 25, 1999 the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On May

25, 1999 the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> On July 2, 1999 the Exchange submitted Amendment No. 3 to the proposed rule change.<sup>5</sup> Notice of the proposal was published in the **Federal Register** on July 22, 1999.<sup>6</sup> On September 1, 1999 the Exchange filed Amendment No. 4 to the proposed rule change. The Commission received no comment on the proposal. This order approves the proposal.<sup>7</sup>

## II. Description of the Proposal

Generally, public customer market and marketable limit orders for up to twenty options contracts may be automatically executed through the Exchange's Auto-Ex system. The Exchange proposes to change its rules on the automatic execution of equity and index option orders by increasing the maximum number of contracts that may be designated for automatic execution, on an issue-by-issue basis, to fifty contracts.<sup>8</sup> The PCX proposes to

Director, Division of Market Regulation, Commission, dated February 24, 1999.

<sup>4</sup> In Amendment No. 2 the Exchange proposed to add subsection (k) to PCX Rule 6.87 to address the allocation of Auto-Ex orders. See letter from Robert P. Pacileo, Staff Attorney, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation, Commission, dated May 24, 1999.

<sup>5</sup> In Amendment No. 3 the Exchange replaced the proposal in its entirety to restate and clarify the purpose of the proposal, to address technical modifications to PCX Rule 6.87 made in a separate filing with the Commission (SR-PCX-99-23), and to add a proposal to amend PCX Rule 6.86 regarding trading crowd firm disseminated market quotes. See letter from Robert P. Pacileo, Staff Attorney, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation, Commission, dated July 1, 1999.

<sup>6</sup> See Securities Exchange Act Release No. 41611 (July 9, 1999), 64 FR 39548.

<sup>7</sup> In Amendment No. 4 the Exchange proposed to allow a notice and comment period for market makers and Lead Market Makers ("LMMs") subject to PCX Rule 6.87(k)(1)(C). See letter from Robert P. Pacileo, Staff Attorney, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation, Commission, dated August 31, 1999 ("Amendment No. 4").

<sup>8</sup> The Commission approved the Pacific Options Exchange Trading System ("POETS") and its Auto-Ex feature as a pilot program in January 1990. See Securities Exchange Act Release No. 27633 (January 18, 1990), 55 FR 2466 (January 24, 1990) (order approving File No. SR-PSE-89-26). On July 30, 1993, the Commission approved the program on a permanent basis. See Securities Exchange Act Release No. 32703 (July 30, 1993), 58 FR 42117 (August 6, 1993). The Auto-Ex system permits eligible market or marketable limit orders sent from member firms to be executed automatically at the displayed bid or offering price. Participating market makers are designated as a contra side to each Auto-Ex order. Participating market makers are assigned by Auto-Ex on a rotating basis, with the first market maker selected at random from the list of signed-on market makers. Auto-Ex preserves Book priority in all options. Automatic executions through Auto-Ex are currently available for public customer orders of ten contracts or less (or in certain issues, for twenty contracts or less) in all series of options traded on the Options Floor of the Exchange.

distinguish between equity and index options for matters relating to increasing the maximum number of contracts that may be designated for automatic execution.<sup>9</sup> The Exchange proposes to increase the maximum size of equity option orders that the Options Floor Trading Committee ("OFTC") may designate for automatic execution in an increase from twenty to fifty contracts and to allow the OFTC to determine the size of index options orders that are eligible to be executed through Auto-Ex with a maximum order size of fifty contracts for the following Index Options: (1) The PSE Technology Index; (2) the Wilshire Small Cap Index; and (3) the Morgan Stanley Emerging Growth Index.<sup>10</sup>

In addition, the Exchange proposes to add subsection (k) to PCX Rule 6.87 to address the allocation of Auto-Ex orders. Specifically, the Exchange proposes that the OFTC will determine, on an issue-by-issue basis, the manner in which orders entered through the Auto-Ex system will be assigned to individual market makers for execution. Each market maker who is participating on the Auto-Ex system will be required to execute a maximum of ten option contracts per Auto-Ex trade, except that the OFTC may permit individual market makers and LMM to be allocated a number of contracts greater than ten and no more than fifty, upon the request of the individual market maker or LMM. Further, the Exchange proposes that, in accordance with the provision of LMMs' guaranteed participation in PCX Rule 6.82(d)92), the LMM in an issue will be required to either (i) participate in every other trade executed on Auto-Ex in that issue or (ii) participate in a percentage of every trade consistent with the amount of the LMM's guaranteed participation.

<sup>9</sup> Currently, PCX Rule 6.87(c) provides: "The Options Floor Trading Committee may increase the size of Auto-Ex-eligible orders in one or more classes of multiply traded equity options to the extent that other options exchanges permit such larger-size orders in multiply traded equity options of the same class or classes to be entered into their own automated execution systems. If the Options Floor Trading Committee intends to increase the Auto-Ex order size eligibility pursuant to this subsection, the Exchange will notify the Securities and Exchange Commission pursuant to Section 19(b)(3)(A) of the Exchange Act." In addition, PCX Rule 6.28(9) provides that the Exchange may increase the permissible size of orders that may be automatically executed over the Auto-Ex system to up to 50 contracts only during high volume or high volatility emergency situations. See Securities Exchange Act Release No. 41481 (June 4, 1999), 64 FR 31674 (June 11, 1999).

<sup>10</sup> The PCX Technology Department has confirmed that POETS is capable of, and has the capacity to, execute trade at 50-up on an issue-by-issue basis, which can equate to floor-wide 50-up if done for all issues.

<sup>16</sup> 15 U.S.C. 78s(b)(2).

<sup>17</sup> In approving Amendment No. 2, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>18</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> In Amendment No. 1 the Exchange proposed to set the maximum order size for execution through its Automatic Execution System ("Auto-Ex") for equity options and for index options on the PSE Technology Index, the Wilshire Small Cap Index, and the Morgan Stanley Emerging Growth Index at fifty contracts. Additionally, in Amendment No. 1 the PCX withdrew SR-PCX-99-05, which was filed with the Commission on February 22, 1999. See Letter from Robert P. Pacileo, Staff Attorney, PCX, to Michael A. Walinskas, Deputy Associate