

the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal offices of the Exchange. All submissions should refer to File No. SR-NYSE-99-25 and should be submitted by March 2, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42384; File No. SR-PCX-99-10]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc. Amending Its Disciplinary Procedures

February 3, 2000.

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> notice is hereby given that on April 2, 1999, the Pacific Exchange, Inc. ("PCX" 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 PCX. On June 25, 1999, the PCX filed with the Commission Amendment No. 1 to the proposed rule change.<sup>3</sup> On January 18, 2000, the PCX filed with the Commission Amendment No. 2 to the proposed rule change.<sup>4</sup> On January 19, 2000, the PCX filed with the Commission Amendment No. 3 to the proposed rule change.<sup>5</sup> The Commission

is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The PCX is proposing to amend its rules on disciplinary proceedings at the Exchange,<sup>6</sup> and in particular, to add new rules to codify the independent function of PCX Regulatory Staff; to clarify what communications are improper in the context of pending investigations or disciplinary proceedings; to provide PCX Regulatory Staff with the ability to issue formal complaints for the alleged violation of Exchange rules; to permit qualified persons who are not members to serve on hearing panels; and otherwise to codify procedures relating to hearing panelists' conflicts of interest. Below is the text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in [brackets].

\* \* \* \* \*

#### Rule 10

##### Disciplinary Jurisdiction and Appeals

###### ¶6061 Disciplinary Jurisdiction

Rule 10.1—No change.

###### ¶6067 Investigations and Regulatory Cooperation

Rule 10.2(a). The Exchange *Regulatory Staff will function independently of the commercial interests of the Exchange members and will have the sole discretion to investigate, and will [shall] investigate,* possible violations within the disciplinary jurisdiction of the Exchange. [upon order of the Board of Governors, the Executive Committee, the Ethics and Business Conduct Committee, or the Floor Trading Committees or upon receipt of a complaint alleging such violations filed by a member or by any other person.] *No member of the Board of Governors or the Executive Committee or non-Regulatory Staff may interfere with or attempt to influence the process or resolution of any pending investigation or disciplinary proceeding.* [All such complaints should specify in reasonable detail the facts constituting the violation, including the specific statutes, Exchange Constitutional provisions, Rules, commentaries, resolutions, policies or procedures allegedly violated. A member or person

associated with a member is entitled to be represented by counsel during any Exchange investigation.

(b) No member or person associated with a member shall impede or delay an Exchange investigation with respect to possible violations within the disciplinary jurisdiction of the Exchange nor refuse to furnish testimony, documentary materials or other information requested by the Exchange during the course of its investigation. Failure to furnish such testimony, documentary materials or other information requested by the Exchange pursuant to this Rule on the date or within the time period required by the Exchange shall be considered obstructive of an Exchange inquiry or investigation and subject to formal disciplinary action.]

(b) *Any person, any Exchange committee, the Board of Governors or the Executive Committee may submit for investigation a complaint alleging possible violations. Each complaint must specify in reasonable detail the facts constituting the violation and any specific federal statute, rule, regulation or Exchange constitutional provision, rule, commentary, resolution, policy or procedure allegedly violated.*

[(c) A member or member organization shall submit such trade data elements specified in Commentary .01 below in such automated format as may be prescribed by the Exchange from time to time, in regard to such transaction or transactions as may be the subject of a particular request for information made by the Exchange. Failure to submit such data in the required format shall be considered obstructive of an Exchange inquiry or investigation and subject to formal disciplinary action.]

(c) *A member, member organization or associated person is entitled to be represented by counsel during any Exchange investigation.*

[(b)] (d) No member, member organization, [or person associated with a member] *associated person or other person or entity over whom the Exchange has jurisdiction pursuant to Rule 10.1(b) may [shall] impede or delay an Exchange investigation with respect to possible violations within the disciplinary jurisdiction of the Exchange nor refuse to furnish testimony, documentary materials or other information requested by the Exchange during the course of its investigation. Failure to furnish such testimony, documentary materials or other information requested by the Exchange pursuant to this Rule on the date or within the time period required by the Exchange [shall] will be*

<sup>8</sup> 17 CFR 200.3-3(a)(12).

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

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

<sup>3</sup> See letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation, Commission, dated June 24, 1999 ("Amendment No. 1"). In Amendment No. 1, the Exchange withdrew proposed PCX Rule 10.8, *Hearing Panels*, and renumbered two of the proposed rules.

<sup>4</sup> See letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Jennifer Colihan, Attorney, Division of Market Regulation, Commission, dated January 7, 2000 ("Amendment No. 2"). In Amendment No. 2, the Exchange proposed to delete PCX Rule 10.4(f) among other things.

<sup>5</sup> See letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Kelly Riley, Attorney, Division of Market Regulation, Commission, dated January 14, 2000 ("Amendment No. 3"). In Amendment No. 3, the Exchange proposed to make minor word change and change the heading for proposed Rule 10.4(c) from "Summary Proceedings" to "Summary Determinations" among other things.

<sup>6</sup> The Commission notes that the Exchange has proposed a similar disciplinary structure and procedures for the Pacific Equities, Inc. See Exchange Act Release No. 42178 (Nov. 24, 1999) 64 FR 68136 (Dec. 6, 1999) (File No. SR-PCX-99-39).

considered obstructive of an Exchange inquiry or investigation and subject to formal disciplinary action.

[(c)] (e) A member or member organization [shall] *must* submit such trade data elements specified in Commentary .01 below in such automated format as may be prescribed by the Exchange from time to time, in regard to such transaction or transactions as may be the subject of a particular request for information made by the Exchange. Failure to submit such data in the required format [shall] *will* be considered obstructive of an Exchange inquiry or investigation and subject to formal disciplinary action.

*Commentary:*

.01—No change.

### **[Regulatory Cooperation]**

[(d)] (f) No member, member organization, *associated person* [person associated with a member or member organization], or other person or entity over whom the Exchange has jurisdiction pursuant to Rule 10.1(b), [shall] *may* refuse to appear and testify before another exchange or self-regulatory organization in connection with a regulatory investigation, examination, or disciplinary proceeding or refuse to furnish documentary materials or other information or otherwise impede or delay such investigation, examination or disciplinary proceeding if the Exchange requests such information or testimony in connection with any inquiry resulting from an agreement entered into by the Exchange pursuant to Rule 14.1 The requirements of this Rule [10.2(d)] 10.2(f) [shall] *will* apply regardless of whether the Exchange has initiated an investigation pursuant to Rule 10.2(a) or a disciplinary proceeding pursuant to Rule [10.3] 10.5.

*Commentary:*

.01 The terms “exchange” and “self-regulatory organization,” as used in Rule [10.2(d)] 10.2(f), [shall] *will* include, but are not limited to, any member or affiliate member of the Intermarket Surveillance Group.

.02 Any person or entity required to furnish information or testimony pursuant to Rule [10.2(d)] 10.2(f) [shall] *will* be afforded the same rights and procedural protections as that person or entity would have if the Exchange had initiated the request for information or testimony.

### **Ex Parte Communications**

10.3(a) *Prohibited Communications. Unless on adequate notice and*

*reasonable opportunity for all parties to participate:*

(1) *No person who is a subject of a pending Exchange investigation (“Subject”) or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent, with knowledge of a pending Exchange investigation or disciplinary proceeding, may make or knowingly cause to be made an ex parte communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) a member of the Board of Governors; (b) a member of the Executive Committee; (c) a person who advises the Board of Governors or the Executive Committee; (d) any member or Exchange Regulatory Staff that is not participating in the resolution of the investigation or the disciplinary proceeding; or (e) a member of a Hearing Panel or the disciplinary committee with jurisdiction over the investigation or disciplinary proceeding.*

(2) *No person who is a member of a Hearing Panel or the disciplinary committee with jurisdiction over an investigation or disciplinary proceeding, with knowledge of a pending investigation or disciplinary proceeding, may make or knowingly cause to be made an ex parte communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) a member of the Board of Governors; (b) a member of the Executive Committee; (c) a person who advises the Board of Governors or the Executive Committee; (d) any member of Exchange Regulatory Staff; or (e) the Subject of a pending Exchange investigation or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent.*

(3) *No person who is a member of the Board of Governors or the Executive Committee, or any person who advises the Board of Governors or the Executive Committee, with knowledge of a pending investigation or disciplinary proceeding, may knowingly make or cause to be made an ex parte communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) any member of Exchange Regulatory Staff; (b) the Subject of a pending Exchange investigation or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent; or (c) a member of a Hearing Panel or the disciplinary committee with jurisdiction over the investigation or disciplinary proceeding.*

(b) *Disclosure of Prohibited Communications. Any person who receives, makes or knowingly causes to be made a communication prohibited by this Rule must promptly submit to Exchange Regulatory Staff for inclusion in the record of the investigation or disciplinary proceeding:*

(1) *All such written communications;*  
 (2) *Memoranda stating the substance of all such oral communications; and*  
 (3) *All written responses and memoranda stating the substance of any oral responses to such communications.*

(c) *Remedies. Any member, member organization or associated person who made or knowingly caused to be made a communication prohibited by subsection (a) will be subject to disciplinary action. Furthermore, an Exchange disciplinary committee, to the extent consistent with the interests of justice, may issue to the member, member organization or associated person responsible for the communication or who benefited from the communication an order to show cause why the claim, defense or interest of the member, member organization or associated person should not be adversely affected by reason of such ex parte communication, including but not limited to the entry of an adverse summary decision. All parties to a disciplinary proceeding and Exchange Regulatory Staff will be provided with adequate notice and a reasonable opportunity to respond to any allegations or contentions contained in the prohibited communication and any responses will be included in the record of the investigation or disciplinary proceeding.*

(d) *Permitted Communications. Nothing in this Rule prohibits the members of a disciplinary committee or Exchange Regulatory Staff from discussing a pending investigation or disciplinary proceeding at a meeting of the committee in connection with: (1) The adjudication of the investigation pursuant to the Minor Rule Plan; (2) the determination of whether to impose informal discipline; (3) the determination of whether to authorize a complaint or take no further action; or (4) the determination of whether to accept an offer of settlement.*

*Commentary:*

.01 “Ex parte communication” means an oral or written communication made without notice to all parties, i.e., Exchange Regulatory Staff and the Subjects of investigations or Respondents in disciplinary proceedings. A written communication is ex parte unless a copy has been previously or simultaneously delivered to all interested parties. An oral

communication is *ex parte* unless it is made in the presence of all interested parties except those who, on adequate prior notice, declined to be present.

.02 A disciplinary proceeding will be considered to be pending from the date that a Complaint has been issued pursuant to Rule 10.5 until the proceeding, including any appeals, becomes final.

#### ¶6073 Complaints [and Answers]

[Rule 10.4] (Note—Rule 10.4 has been renumbered as Rule 10.5)

Rule [10.3]10.4(a) [Whenever it shall appear to the Board of Governors, the Executive Committee, or any standing committee designated by the Board of Governors to review disciplinary proceedings that] *Any standing committee designated by the Board of Governors to review disciplinary proceedings, and Exchange Regulatory Staff designated by the Exchange, has the authority to determine whether there is probable cause for finding that a violation within the disciplinary jurisdiction of the Exchange has occurred and that further proceedings are warranted*[, the]. *If the Exchange (“the Complainant”) determines that further proceedings are warranted, then the Exchange [shall] will initiate a formal disciplinary action by preparing a statement of charges (“the Complaint”) against [the] any [person or] member, member organization or associated person alleged to have committed a violation (“the Respondent”) specifying the acts in which the Respondent is [charged] alleged to have engaged in, or which the Respondent is alleged to have omitted, and [setting forth] alleging the specific provisions of the Securities Exchange Act of 1934, as amended, rules and regulations promulgated thereunder, Exchange constitutional provisions, rules, commentaries, resolutions, policies or procedures, of which such acts or omissions are alleged to be in violation.*

*(b) At any time prior to service of the written answer to the Complaint, the Complaint may be amended to allege new matters of fact or law. After service of the written answer, the hearing panel may allow amendment of the Complaint upon submission of a written motion by the Exchange and a showing of good cause.*

The Respondent shall have fifteen business days after service of the charges to file a written answer thereto. The answer shall specifically admit or deny each allegation contained in the charges, and the Respondent shall be deemed to have admitted any allegation not specifically denied. The answer may

also contain any defense which the Respondent wishes to submit and may be accompanied by documents in support of his answer or defense. In the event the Respondent fails to file an answer, the charges shall be considered to be admitted.

The time period to file any answer may be extended for such further periods as may be granted by the Exchange, if such request for extension of the filing period is received by the Exchange within five business days prior to the date on which the answer is due.

#### Summary Determinations

(c) [Rule 10.5] Notwithstanding the provisions of Rule 10.5, the disciplinary committee with jurisdiction over the proceeding may make a determination without a hearing and may impose a penalty as to such charges which the Respondent has admitted or has failed to answer or which otherwise do not appear to be in dispute. Notice of such summary determination, specifying the violations and penalty, shall be served upon the Respondent.

#### Commentary:

.01 *The term “probable cause” means that facts and circumstances establish a reasonable likelihood that the person committed the violation in issue.*

#### Hearing

[Rule 10.5] (Note: Rule 10.5 has been renumbered as Rule 10.4(c))

[Rule 10.4] *Rule 10.5(a)* Upon Respondent’s filing an answer, the Respondent may request a hearing. An appropriate Committee of the Exchange (“the Hearing Committee”) shall appoint one or more members to hear the matter (“the Panel”). Parties shall be given at least 15 calendar days notice of the time and place of the hearing and a statement of the matters to be considered therein.

(b) Prior to the hearing, the Parties shall be notified of the composition of the Panel. Any objection to the composition of the Panel must be submitted to the Hearing Administrator within five business days of receipt of the notification regarding the composition of the Panel.

(c) At least five business days prior to the hearing the parties shall submit to the Hearing Administrator a list of witnesses and any documentary evidence or other materials to be presented at the hearing. The Hearing Administrator shall immediately furnish such list of witnesses, documentary evidence or other materials to the other parties.

(d) At the hearing, both the Complainant and the Respondent shall be entitled to be heard in person and to present any relevant matter. Any witnesses, testimony or evidence offered by the Complainant or the Respondent shall be subject to cross-examination by the other party. The Panel shall determine all questions concerning the admissibility of evidence and shall otherwise regulate the conduct of the hearing. Formal rules of evidence shall not apply. The charges shall be presented by one or more representatives of the Exchange, who along with Respondent and any other party, may present evidence and produce witnesses who shall testify under oath and are subject to being questioned by the Panel and other parties. The Panel, upon its own motion or the motion of the Complainant or Respondent, may request the production of documentary materials and witnesses. No member or person associated with a member shall refuse to furnish relevant testimony, documentary materials or other information requested by the Panel during the course of the hearing. The Respondent and intervening parties are entitled to be represented by counsel who may participate fully in the hearing. A transcript for the hearing shall be made and shall become part of the record.

(e) Any person not otherwise a party may intervene as a party to the hearing upon demonstrating to the satisfaction of the Panel that he has an interest in the subject of the hearing and that the disposition of the matter may, as a practical matter, impair or impede his ability to protect that interest. Also, the Panel may in its discretion permit a person to intervene as a party to the hearing when the person’s claim or defense and the main action have questions of law or fact in common. Any person wishing to intervene as a party to a hearing shall file with the Panel a notice requesting the right to intervene, stating the grounds therefor, and setting forth the claim or defense for which intervention is sought. The Panel, in exercising its discretion concerning intervention, shall take into consideration whether the intervention will unduly delay or prejudice the adjudication of the rights of the original parties.

[(f) Except in writing, with copies to the other parties, neither the Complainant, the Respondent, nor any interested party may discuss with the Panel any matter concerning the facts or allegations in the complaint unless the other parties to the action are given

sufficient notice and an opportunity to be heard.]

Rules 10.6–10.14—No change.

\* \* \* \* \*

## 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 PCX 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 PCX 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

*Independence of Regulatory Staff.* The Exchange is proposing to modify PCX Rule 10.2 so that it will include new provisions on the independence of PCX Regulatory Staff and its separation from the Exchange's commercial interests. Specifically, the rule is being modified to state that the Exchange's Regulatory Staff will function independently of the commercial interests of the Exchange members and will have the sole discretion to investigate, and will investigate, possible violations within the disciplinary jurisdiction of the Exchange. The proposed rule further states specifically that no member of the Board of Governors or the Executive Committee or non-Regulatory Staff may interfere within or attempt to influence the process or resolution of any pending investigation or disciplinary proceeding.

*Investigations.* The Exchange is proposing to reorganize the provisions on Exchange investigations and to make various technical and housekeeping changes to the text of PCX Rule 10.2, which will now cover both Exchange investigations and regulatory cooperation.<sup>7</sup>

*Ex Parte Communications.* The Exchange is proposing to adopt new PCX Rule 10.3 to codify specific provisions on ex parte communications.<sup>8</sup> This rule change codifies what communications regarding pending investigations and

disciplinary proceedings are improper. The Exchange believes that this rule change will serve to assure that the integrity and independence of the Exchange's regulatory function will be protected.

More specifically, proposed Exchange Rule 10.3(a)(1) provides that unless on adequate notice and reasonable opportunity for all parties to participate, no person who is a subject of a pending Exchange investigation ("Subject") or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent, with knowledge of a pending Exchange investigation or disciplinary proceeding, may make or knowingly cause to be made an *ex parte* communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) a member of the Board of Governors; (b) a member of the Executive Committee; (c) a person who advises the Board of Governors or the Executive Committee; (d) any member of Exchange Regulatory Staff that is not participating in the resolution of the investigation or the disciplinary proceeding; or (e) a member of a Hearing Panel or the disciplinary committee with jurisdiction over the investigation or disciplinary proceeding.<sup>9</sup>

Proposed PCX Rule 10.3(a)(2) provides that unless on adequate notice and reasonable opportunity for all parties to participate, no person who is a member of a Hearing Panel or the disciplinary committee with jurisdiction over an investigation or disciplinary proceeding, with knowledge of a pending investigation or disciplinary proceeding, may make or knowingly cause to be made an *ex parte* communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) A member of the Board of Governors; (b) a member of the Executive Committee; (c) a person who advises the Board of Governors or the Executive Committee; (d) any member of Exchange Regulatory Staff; or (e) the Subject of a pending Exchange investigation or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent.<sup>10</sup>

Proposed Rule 10.3(a)(3) provides that unless on adequate notice and reasonable opportunity for all parties to participate, no person who is a member of the Board of Governors or the Executive Committee, or any person who advises the Board of Governors or

the Executive Committee, with knowledge of a pending investigation or disciplinary proceeding, may knowingly make or cause to be made an *ex parte* communication, as defined below, relevant to the facts or allegations of the investigation or the disciplinary proceeding to: (a) Any member of Exchange Regulatory Staff; (b) the Subject of a pending Exchange investigation or a Respondent in a pending disciplinary proceeding, or counsel for or a representative of the Subject or the Respondent; or (c) a member of a Hearing Panel or the disciplinary committee with jurisdiction over the investigation or disciplinary proceeding.<sup>11</sup>

With respect to the disclosure of prohibited communications, proposed PCX Rule 10.3(b) provides that any person who receives, makes or knowingly causes to be made a communication prohibited by this Rule must promptly submit to Exchange Regulatory Staff for inclusion in the record of the investigation or disciplinary proceeding: (1) All such written communications; (2) memoranda stating the substance of all such oral communications; and (3) all written responses and memoranda stating the substance of any oral responses to such communications.<sup>12</sup>

Proposed Exchange Rule 10.3(c) sets forth remedies applicable to situations in which prohibited communications have been made. Specifically, the rule provides that any member, member organization or associated person who made or knowingly caused to be made a communication prohibited by subsection (a) will be subject to disciplinary action. The rule further provides that an Exchange disciplinary committee, to the extent consistent with the interests of justice, may issue to the member organization or associated person responsible for the communication or who benefited from the communication an order to show cause why the claim, defense or interest of the member, member organization or associated person should not be adversely affected by reason of such *ex parte* communication, including but not limited to the entry of an adverse summary decision. The rule further provides that all parties to a disciplinary proceeding and Exchange Regulatory Staff will be provided with adequate notice and a reasonable opportunity to respond to any allegations or contentions contained in the prohibited communication and any responses will be included in the record of the

<sup>7</sup> The current provisions on regulatory cooperation are set forth in PCX Rule 10.2(d).

<sup>8</sup> These provisions were, in large part, adapted from the NASD Manual—Code of Procedure ("NASD Code of Proc.") Rule 9143, *Ex Parte Communications*.

<sup>9</sup> Cf. NASD Code of Proc. Rule 9143(a)(1).

<sup>10</sup> Cf. NASD Code of Proc. Rule 9143(a)(2).

<sup>11</sup> Cf. NASD Code of Proc. Rule 9143(a)(1)–(2).

<sup>12</sup> Cf. NASD Code of Proc. Rule 9143(b).

investigation or disciplinary proceeding.<sup>13</sup>

Proposed PCX Rule 10.3(d) clarifies that nothing in the rule on ex parte communications prohibits the members of a disciplinary committee or Exchange Regulatory Staff from discussing a pending investigation or disciplinary proceeding at a meeting of the committee in connection with: (1) The adjudication of the investigation pursuant to the Minor Rule Plan; (2) the determination of whether to impose informal discipline; (3) the determination of whether to authorize a complaint or take no further action; or (4) the determination of whether to accept an offer of settlement.

Proposed Commentary .01 to Exchange Rule 10.3 defines an "ex parte communication" as an oral or written communication made without notice to all parties, *i.e.*, Exchange Regulatory Staff and the Subjects of investigations or Respondents in disciplinary proceedings. The Commentary further states that a written communication is ex parte unless a copy has been previously or simultaneously delivered to all interested parties. It further provides that an oral communication is ex parte unless it is made in the presence of all interested parties except those who, on adequate prior notice, declined to be present.<sup>14</sup>

Finally, proposed Commentary .02 to PCX Rule 10.3 states that a disciplinary proceeding will be considered to be pending from the date that a Complaint has been issued pursuant to Rule 10.5 until the proceeding, including any appeals, becomes final. This provision will serve to clarify the scope of statements prohibited by PCX Rule 10.3.<sup>15</sup>

**Complaints.** PCX Rule 10.3, which the PCX proposes to renumber as Rule 10.4, currently provides that formal complaints for alleged violations of Exchange rules (and other provisions) may be authorized by the PCX Board of Governors, by the Executive Committee of the Exchange, or by any standing committee designated by the Board of Governors to review disciplinary proceedings. The Exchange is proposing to modify that provision so that only Exchange Regulatory Staff designated by the Exchange and any standing committee designated by the Board of

Governors to review disciplinary proceedings has the authority to determine whether there is probable cause to issue a formal complaint, *i.e.*, probable cause for finding that a violation within the disciplinary jurisdiction of the Exchange has occurred and that further proceedings are warranted. The PCX also proposes to make certain technical changes to the text of current Exchange Rule 10.3 for clarification purposes, *e.g.*, changing the term "charged" to "alleged."

With regard to amending outstanding Complaints, proposed PCX Rule 10.4(b) provides that at any time prior to service of the written answer to the Complaint, the Complaint may be amended to allege new matters of fact or law. It further provides that after service of the written answer, the hearing panel may allow amendment of the Complaint upon submission of a written motion by the Exchange and a showing of good cause.

Finally, the Exchange is proposing to adopt new Commentary .01 to new PCX Rule 10.4 to provide that the term "probable cause" means that facts and circumstances establish a reasonable likelihood that the person committed the violation in issue.

**Summary Determinations.** The Exchange proposes to renumber PCX Rule 10.5 to Rule 10.4(c).

## 2. Statutory Basis

The PCX believes the proposed rule change is consistent with Section 6(b) <sup>16</sup> of the Act, in general, and furthers the objectives of Section 6(b)(5),<sup>17</sup> in particular, in that it is designed to promote just and equitable principles of trade and to protect investors and the public interest. The PCX also believes that the proposal is consistent with Section 6(b)(6) <sup>18</sup> of the Act in that it is designed to assure that Exchange members and persons associated with Exchange members are appropriately disciplined for violations of the Act, the rules and regulations thereunder, and the rules of the Exchange.

## 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 that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Written comments on the proposed rule change were neither solicited nor received.

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

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve the proposed rule change, or

(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 at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the PCX.

All submissions should refer to File No. SR-PCX-99-10 and should be submitted by March 2, 2000.

<sup>13</sup> Cf. NASD Code of Proc. Rule 9143(c).

<sup>14</sup> Cf. Chicago Board Options Exchange ("CBOE") Rule 17.4, Interpretation and Policy .01.

<sup>15</sup> See, *e.g.*, proposed PCX Rule 10.3(a)(1) ("No person who is \* \* \* a Respondent in a pending disciplinary proceeding, may make \* \* \* and ex parte communication. \* \* \*" (emphasis added)). Cf. CBOE Rule 17.14, Interpretation and Policy .01(i).

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

<sup>17</sup> 15 U.S.C. 78f(b)(5).

<sup>18</sup> 15 U.S.C. 78f(b)(6).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

Margaret H. McFarland,

Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42386; File No. SR-Phlx-98-55]

### Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.: Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Relating to an Increase in Position and Exercise Limits for Certain Broad-Based Index Options

February 4, 2000.

#### I. Introduction

On December 21, 1998 the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to increase broad-based ("market") index option position and exercise limits on the Value Line Composite Index ("VLE"), the US Top 100 Index ("TPX"), and the National Over-the-Counter Index ("XOC").<sup>3</sup>

The proposed rule change was published for comment in the **Federal Register** on April 2, 1999.<sup>4</sup> No comments were received on the proposal. On November 10, 1999, the Phlx filed an amendment to the proposed rule change.<sup>5</sup> This order approves the proposal, as amended.

#### II. Description

The Phlx proposed to amend Phlx Rule 1001A(a)(i)-(ii) by increasing market index option position limits on

the VLE, the TPX, and the XOC.<sup>6</sup> Specifically, the Phlx proposed to triple the current levels of 25,000 contracts total and 15,000 contracts in the nearest expiration month for the VLE and the TPX to 75,000 contracts total and 45,000 contracts in the nearest expiration month. The Phlx also proposed to triple position and exercise limits for the XOC from 25,000 contracts total to 75,000 contracts total.

Exchange exercise limits,<sup>7</sup> which are expressed in Phlx Rule 1002A, are established by reference to position limits, such that any increase in position limits would also increase exercise limits. Accordingly, the Phlx proposed to increase exercise limits to correspond to the proposed increases in position limits.

#### III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Sections 6 of the Act.<sup>8</sup> Specifically, the Commission believes that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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.

Position limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In the past, the Commission has stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to

<sup>6</sup> Position limits impose a ceiling on the number of option contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls) that can be held or written by an investor or group of investors acting in concert.

<sup>7</sup> Exercise limits prohibit an investor or group of investors acting in concert from exercising more than a specified number of puts or calls in a particular class within five consecutive business days.

<sup>8</sup> See 15 U.S.C. 78f(b). In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with Section 3 of the Act. *Id.* at 78c(f).

manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.<sup>9</sup>

In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits.<sup>10</sup> The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set option position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the component securities comprising the indexes. At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market-makers from adequately meeting their obligations to maintain a fair and orderly market.<sup>11</sup>

The Commission has carefully considered the Phlx's proposal. At the outset, the Commission notes that it still believes that the fundamental purposes of position and exercise limits are being served by their existence. Nevertheless, the Commission believes that the Phlx's current experience with the trading of market index options<sup>12</sup> make it

<sup>9</sup> Exchange Act Release Nos. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11) (order approving an increase in OEX position and exercise limits); 31330 (October 16, 1992), 57 FR 48408 (October 23, 1992) (SR-Amex-92-13) (order approving an increase in Institutional Index Options position and exercise limits).

<sup>10</sup> Position and exercise limits for the XOC were raised from 17,000 to 25,000 contracts in 1996. Position and exercise limits for the VLE were raised from approximately 13,000 contracts, based on a position limit based on monetary value, to 25,000 contracts in 1988. The US Top 100 Index was created with limits of 25,000 contracts in 1995. See Exchange Act Release No. 36745 (January 19, 1996), 61 FR 2561 (January 26, 1996) (SR-Phlx-95-38) (establishing XOC position and exercise limits); Exchange Act Release No. 35591 (April 11, 1995), 60 FR 19423 (April 18, 1995) (SR-Phlx-95-07) (establishing TPX position and exercise limits); Exchange Act Release No. 25644 (May 3, 1988), 53 FR 16829 (May 11, 1988) (SR-Phlx-88-06) (establishing VLE position and exercise limits). See also Exchange Act Release Nos. 37676 (September 13, 1996), 61 FR 49508 (September 20, 1996) (order approving SR-CBOE-96-01, increasing position limits for the SPX from 45,000 to 100,000 contracts); 39789 (December 24, 1997), 63 FR 276 (January 5, 1998) (order approving SR-CBOE-97-11, increasing position limits for the OEX from 75,000 to 150,000 contracts). See also *infra* note 19.

<sup>11</sup> See H.R. Rep. No. IFC-3, 96th Cong., 1st Sess. At 189-91 (Comm. Print 1978).

<sup>12</sup> The Phlx has been trading market index options since 1985. See Exchange Act Release No.

<sup>19</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> Position limits impose a ceiling on the number of option contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls) that can be held or written by an investor or group of investors acting in concert.

<sup>4</sup> See Exchange Act Release No. 41216 (March 26, 1999), 64 FR 16019.

<sup>5</sup> See Letter from John Dayton, Phlx, to Nancy Snow, Commission, dated November 9, 1999 ("Amendment No. 1").