

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47469; File No. SR-Amex-2002-104]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the American Stock Exchange LLC Relating to Amex Rules 26, 29, 171, and 950 To Revise Specialist Capital Requirements and the Method for Computing Specialist Capital Requirements and To Create an Early Warning Level With Respect to Specialist Capital

March 7, 2003.

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 December 10, 2002, the American Stock Exchange LLC ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in items I, II, and III below, which items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Amex proposes to amend Amex rules 26, 29, 171, and 950 to (1) revise specialist capital requirements and the method for computing specialist capital requirements, and (2) to create an early warning level with respect to specialist capital. The text of the proposed rule change is below. Text in brackets indicates material to be deleted, and text in italics indicates material to be added.

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#### Performance Committee

Rule 26. (a) No change.

(b) The Performance Committee shall review, and approve, disapprove or conditionally approve, mergers and acquisitions of specialist units, transfers of one or more specialist registrations, specialist joint accounts, and changes in control or composition of specialist units. The Performance Committee shall approve a proposed transaction involving a specialist unit unless it determines that a countervailing institutional interest indicates that the transaction should be disapproved or conditionally approved. In determining whether there is a countervailing institutional interest, the Performance

Committee shall consider the maintenance or enhancement of the quality of the Exchange's market, taking into account the criteria that the Allocations Committee may consider in making an initial allocation determination (Rule 27(b)) and other considerations as may be relevant in the particular circumstances.

The Performance Committee shall evaluate specialists, individually and/or collectively as units, to determine whether they have fulfilled performance standards relating to, among other things: (1) Quality of markets, (2) competition with other markets, (3) observance of ethical standards, and (4) administrative factors. The Performance Committee may consider any relevant information, including but not limited to the results of the Specialist Floor Broker Questionnaire, trading data, a member's regulatory history, order flow statistics, and such other factors and data as may be pertinent in the circumstances. *The Performance Committee also may review specialists, individually and/or collectively as units, with respect to capital requirements and the "early warning level" set forth in Commentary .06 to rule 171.* The Performance Committee may take one or more of the following actions if it finds that a specialist or unit has failed to properly perform as a specialist: (1) Send admonitory letters, (2) refer matters to the Minor Floor Violation Disciplinary Committee for possible action pursuant to Exchange rule 590, (3) refer matters to the Exchange's Enforcement Department for investigation and possible disciplinary proceedings, (4) counsel specialists on how to improve their performance, (5) require specialists to adopt a performance improvement plan, (6) reorganize specialist units, (7) require the reallocation of securities, (8) suspend a specialist's or unit's registration as a specialist for a specific period of time, or (9) prohibit a specialist or unit from receiving allocations in a particular situation or for a specified period of time. In appropriate circumstances, the Performance Committee may confine a prohibition on new allocations to one of the three classes of securities traded on the Exchange (*i.e.*, equities, Exchange Traded Funds or options), or otherwise target a remedial action to a particular class of security traded by a specialist or unit.

(c) and (d) No change.

(e) The Performance Committee may meet with one or more specialists, specialist units, registered traders or brokers that may have failed to meet minimum performance standards,

*capital requirements, or the "early warning level" set forth in Commentary .06 to rule 171.* In such an event, the member or members shall be notified in writing of the grounds to be considered by the Performance Committee and afforded an opportunity to make a presentation of relevant information in rebuttal. Such member or members shall be given access to all written material to be reviewed by the Performance Committee, and all persons appearing before the Performance Committee may be represented by counsel. However, formal rules of evidence shall not apply in Performance Committee meetings. A failure to meet minimum performance standards, *capital requirements, or early warning level* may form the basis for Performance Committee remedial action against one or more specialists, specialist units, registered traders or brokers. Any member or member organization affected by a decision of the Performance Committee shall be informed in writing of the decision, which decision shall include the findings, conclusions, any remedial action to be taken (hereinafter "written notification"). (f) through end. No Change.

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#### Market Quality Committee

Rule 29. (a) No change.

(b) The Market Quality Committee shall evaluate the performance of specialists registered in securities admitted to dealings on an unlisted basis ("UTP Specialists") with respect to, among other things: (1) Quality of markets, (2) competition with other market centers, (3) administrative matters, and (4) willingness to promote the Exchange as a marketplace. The Market Quality Committee may consider any relevant information, including but not limited to trading data, order flow statistics, market quality statistics, and such other factors and data pertaining to both the Amex and other market centers as may be relevant in the circumstances. *The Market Quality Committee also may review specialists, individually and/or collectively as units, with respect to capital requirements and the "early warning level" set forth in Commentary .06 to rule 171.* The Market Quality Committee may take one or more of the following actions if it finds that the performance of the UTP Specialist is inadequate relative to one or more of the above factors: (1) Send advisory letters, (2) counsel UTP Specialists on how to improve their market quality, (3) require UTP Specialists to adopt a performance improvement plan, (4) require the reallocation of securities, (5) suspend a

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

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

UTP Specialist's registration as a specialist for a specific period of time, or (6) prohibit a UTP Specialist from receiving allocations in a particular situation or for a specified period of time.

(c) No change.

(d) The Market Quality Committee may meet with a UTP Specialist that may have failed to meet minimum performance standards with respect to UTP Securities, *capital requirements*, or the "early warning level" set forth in *Commentary .06 to rule 171*. In such an event, the UTP Specialist shall be notified in writing of the grounds to be considered by the Market Quality Committee and afforded an opportunity to make a presentation of relevant information. Such UTP Specialist shall be given access to all written material to be reviewed by the Market Quality Committee, and all persons appearing before the Market Quality Committee may be represented by counsel. However, formal rules of evidence shall not apply in meetings of the Market Quality Committee. A failure to meet minimum standards relating to: (1) Quality of markets, (2) competition with other market centers, (3) administrative matters, [or] (4) willingness to promote the Exchange as a marketplace, or (5) *capital requirements*, or *early warning level* may form the basis for remedial action by the Market Quality Committee against a UTP Specialist. Any UTP Specialist affected by a decision of the Market Quality Committee shall be informed in writing of the decision, which decision shall include the findings, conclusions, and any remedial action to be taken (hereinafter "written notification").

(e) through end. No change.

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**Specialist Financial Requirements**

Rule 171. Every registered specialist shall maintain [a cash or liquid asset position] *tentative net capital* in the amount of [\$600,000] *\$1,000,000* or in an amount sufficient to assume a position of sixty trading units of each security in which such specialist is registered, whichever amount is greater. In the event that two or more specialists are associated with each other and deal for the same specialists account, the above requirement of this rule shall apply to such specialists as one unit, rather than to each specialist individually.

**Commentary**

.01 through .03. No change.

.04 For each security in which a specialist is registered which is principally traded or priced in a U.S.

marketplace other than the Exchange, such specialist shall maintain [a cash or net liquid asset position] *tentative net capital* sufficient to assume a position of twenty trading units of such security.

.05 *The term "tentative net capital" means net capital, computed in accordance with Securities Exchange Act rule 15c3-1 before application of haircuts and undue concentration charges.*

.06 Each specialist or specialist unit subject to this rule, shall promptly notify the Exchange in writing if the tentative net capital of such specialist or specialist unit after deduction of all capital withdrawals including maturities, if any, scheduled during the next six months, falls below 125% of the minimum dollar amount required hereby (the "early warning level").

.07 In the event the tentative net capital of any specialist or specialist unit subject to this rule falls below the early warning level, such specialist or specialist unit shall attempt to reach a written agreement with the Exchange's Financial Regulatory Services Department (FRSD) on a plan for raising the specialist or specialist unit's capital to an appropriate level or taking other appropriate action. In the event of the failure to reach such agreement within five business days following the initial response or involvement of FRSD, FRSD may refer such matter to the Committee on Floor Member Performance or the Market Quality Committee as appropriate to take such action as it shall decide is appropriate.

.08 *For purposes of rule 171, the amount sufficient to assume a position of sixty trading units shall be equal to 15% of the current market value of the position.*

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**Rules of General Applicability**

Rule 950. (a) through (g). No change.

(h) The provisions of rule 171 and *Commentary* thereto shall apply to the trading of option contracts, however, the option specialist financial requirement shall be equal to a minimum of [\$600,000] *\$1,000,000* plus \$25,000 for each option issue in excess of the initial [ten] *twenty-five* issues in which such specialist is registered.

.01 For an option specialist that is also an equity security specialist subject to the requirements of rule 171, the minimum [\$600,000] *\$1,000,000* referred to in rule 171 shall apply to the entirety of the specialist's business, in both equities and options. For example, a specialist maintaining a book in both equity securities and options that is allocated only one equity security and one option (assuming the cost to carry

60 units of the equity stock does not exceed [\$600,000] *\$1,000,000*) would be required to satisfy the minimum financial requirement of [\$600,000] *\$1,000,000*.

(i) through end. No change.

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**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 Amex 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 Amex 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

*Change in Specialist Capital Requirements.* Amex rule 171 currently requires specialist units to maintain a cash or "liquid asset position" in the greater of \$600,000 or an amount sufficient to assume a position of sixty trading units of each security in which such specialist unit is registered. In the case of options specialists, the requirements of Amex rule 171 are superceded by Amex rule 950(h), which requires option specialist units to maintain a cash or "liquid asset position" in the amount of \$600,000 plus \$25,000 for each option issue in excess of the initial ten issues in which the specialist unit is registered. The proposal would amend Amex rule 171 and Amex rule 950(h) to raise the minimum capital requirement for both equity and option specialists to \$1,000,000.

For specialists whose position requirement already exceeds \$1,000,000, this increase would be offset by reductions in the position requirements. Specifically, the proposal would reduce the position requirement for equity specialists from 25% of sixty trading units of each security in which such specialist is registered to 15% of such amount. In the case of option specialists, the proposal would reduce the position requirement from an additional \$25,000 for each option issue in excess of the initial ten issues in which such specialist is registered to an additional \$25,000 for each issue in excess of the initial 25.

*Change in Specialist Capital Computation Method.* The proposal would amend Amex rule 171, and indirectly Amex rule 950(h), to require that specialist units meet their capital requirements with “tentative net capital,” *i.e.*, net capital computed in accordance with Rule 15c3-1 of the Act,<sup>3</sup> before haircut and undue concentration charges, rather than with cash or liquid assets. Use of a tentative net capital standard would provide a better measure of a specialist unit’s financial strength than the current “cash or liquid asset” requirement, since it would take into account all of the specialists’ assets and liabilities—not just those held in the clearing account. Moreover, since all specialists on the Amex are now subject to the net capital rule, use of such a standard should not present any computational or operational difficulties for our specialists. Indeed, those Amex specialists who also act as specialists on the NYSE are already calculating their capital in a similar manner.

*Creation of an Early Warning Level.* As currently drafted, the Exchange’s capital standards for specialists units suffer from an “all or nothing” approach. That is, a specialist either meets the financial requirements or it does not. The Exchange has little actual control or authority over a specialist that, although perhaps headed for financial difficulty, has not yet fallen below the minimum requirement.

Rather than the current “all or nothing” approach, the Exchange is proposing the creation of a so-called early warning level that, if triggered, would allow the Exchange to subject the breaching specialist unit to closer oversight and impose conditions on its operations. The proposed early warning level would be set at 125% of the actual financial requirement and would be calculated in a conservative manner by assuming that subordinated debt and other scheduled capital distributions coming due in less than 180 days have already been paid.

While the Exchange’s Financial Regulatory Services Department (“FRSD”) would monitor for compliance with the early warning level, specialist units would also be required to provide the Exchange with notice in the event they breach the early warning level. In the event of such a breach, the specialist unit would have five business days to reach a written agreement with FRSD on an action plan for raising its capital to an appropriate level. The plan would specify a timetable for bringing capital above the

early warning level or taking other appropriate actions.

In the event the specialist and FRSD are not able to reach agreement on a plan, FRSD would refer the specialist either to the Committee on Floor Member Performance or to the Market Quality Committee with respect to UTP securities. Either of these Committees would have the authority to impose a performance improvement plan on the specialist to increase the specialist’s capital or take other appropriate action. In no event could a written action plan provide for capital requirements below, or otherwise violate, the Exchange’s minimum requirements. A failure by the specialist to meet the conditions in the Committee’s plan could result in disciplinary action, the reallocation of securities, and/or other remedial action to the extent necessary to bring the breaching specialist within continued compliance.

The proposed rule change would not go into effect until one year after approval by the Commission to give firms an opportunity to adjust to the changes.

## 2. Statutory Basis

The proposed rule change is consistent with section 6(b) of the Act<sup>4</sup> in general, and furthers the objectives of section 6(b)(5) of the Act<sup>5</sup> in particular, in that it 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 regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The Exchange believes that the proposed rule change will impose no burden on competition 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*

No written comments were solicited or received in response to the proposed rule change.

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

Within 35 days of the date of 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 to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such 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, 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 Amex. All submissions should refer to File No. SR-Amex-2002-104 and should be submitted by April 4, 2003.

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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<sup>4</sup> 15 U.S.C. 78f(b).

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

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

<sup>3</sup> 17 CFR 240.15c3-1.