

Security does not satisfy these requirements. Additionally, in order to base certification on Commentary .05 of Rule 1009, the closing prices of the Restructure Security on each of the five or more trading days prior to the selection date must be at least \$7.50. Finally, as is required for all underlying securities selected for options trading, trading volume in the Restructure Security must be at least 2,400,000 shares during a period of twelve months or less up to the time the security is so selected.

The effect of the proposed rule change is that a Restructure Security issued pursuant to a public offering or a rights distribution that is part of a reorganization will be eligible for options trading only if it satisfies all of the existing standards applicable to the selection of underlying securities generally, except that (A) the Exchange may assume the satisfaction of the minimum public ownership requirement of 7,000,000 shares and the minimum 2,000 shareholders requirement if (i) either the percentage of value tests of subparagraph (a)(1) of Commentary .05 are met or the aggregate market value represented by the Restructure Security is at least \$500,000,000; and if (ii) the Restructure Security is listed on an exchange or an automatic quotation system having equivalent listing requirements or at least 40,000,000 shares of the Restructure Security are issued and outstanding, and if (iii) after the Restructure Security has traded "regular way" for at least five trading days and after having conducted due diligence in the matter, the Exchange has no reason to believe that these requirements are not met, and (B) subject to the same percentage of value or aggregate market value requirements, the Restructure Security may be deemed to satisfy the minimum market price per share requirement if it has a closing market price per share of at least \$7.50 during each of the five or more trading days preceding the date of selection, instead of having to satisfy this requirement over a majority of days over a period of three months. (In the event the Restructure Security has a closing price that is less than \$7.50 on any of the trading days preceding its selection, it will have to satisfy this requirement on a majority of trading days over a period of three months before it can be certified as eligible for options trading.) For any Restructure Security issued in a public offering or a rights distribution that does satisfy these requirements, the effect of the proposed rule change will be to permit its certification of options

trading to take place as early as on the sixth day after trading in the stock commences, instead of having to wait for three months of trading.

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Securities Exchange Act of 1934 in general, and furthers the objectives of Section 6(b)(5) in particular, by removing impediment to a free and open market in options covering securities issued in public offerings or pursuant to rights distributions as part of restructuring transactions and other similar corporate reorganizations.

#### *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

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 self-regulatory organization 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., 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, NW., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the Phlx. All submissions should refer to the File No. SR-Phlx-95-90 and should be submitted by January 19, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>4</sup>

Margaret H. McFarland,  
Deputy Secretary.

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[Release No. 34-36623; File No. SR-CBOE-95-51]

### **Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to the Proposed Rule Change by the Chicago Board Options Exchange, Incorporated, Relating to the Listing of the Trading of Options and Long-Term Options on the CBOE Automotive Index and Long-Term Options on a Reduced-Value CBOE Automotive Index**

December 21, 1995.

#### I. Introduction

On August 31, 1995, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("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 to provide for the listing and trading of index options on the CBOE Automotive Index ("Automotive Index" or "Index"). Notice of the proposal appeared in the Federal Register on October 5, 1995.<sup>3</sup> No comment letters were received on the proposed rule change. On December 14, 1995, the Exchange filed with the Commission Amendment No. 1 to the proposed change.<sup>4</sup> This order approves the Exchange's proposal, as amended.

<sup>4</sup> 17 CFR 200.30-(a)(12).

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

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

<sup>3</sup> See Securities Exchange Act Release No. 36295 (September 28, 1995), 60 FR 52229.

<sup>4</sup> In Amendment No. 1, as discussed more fully herein, the Exchange proposed certain maintenance standards for the Automotive Index. See Letter from Eileen Smith, Director, Product Development, Research Department, CBOE, to John Ayanian, Attorney, Office of Market Supervision ("OMS"),

Continued

## II. Description of Proposal

### A. General

The CBOE proposes to list for trading options on the Automotive Index, a new securities index developed by the CBOE. The Automotive Index consists of ten companies involved in the design and manufacture of automobiles and automotive parts (replacement and original equipment).<sup>5</sup> The CBOE also proposes to list either long-term options on the full-value Index or long-term options on a reduced-value Index that will be computed at one-tenth of the value of the Automotive Index ("Automotive Index LEAPS" or "Index LEAPS").<sup>6</sup> Automotive Index LEAPS will trade independent of and in addition to regular Index options traded on the Exchange,<sup>7</sup> however, as discussed below, for purposes of position and exercise limits, positions in Index LEAPS and regular Index options will be aggregated.

### B. Composition of the Index

The Index was designed by the Exchange and is comprised of ten companies involved in the design and manufacture of automobiles and automotive parts. The share of each of the components contained in the Index currently trade in the U.S. on the New York Stock Exchange ("NYSE").

As of the close of trading on July 31, 1995, the Index was valued at 179.93. As of the same date, the components comprising the Index ranged in capitalization from \$2.3 billion to \$36.4 billion. The total capitalization as of that date was \$112.2 billion; the mean capitalization was \$11.2 billion; and the median capitalization was \$4.8 billion. The largest component accounted for 20% of the total weighting of the Index, while the smallest accounted for 5.00%. The top five components accounted for 68.33% of the total weight of the Index.<sup>8</sup>

Division of Market Regulation ("Market Regulation"), Commission, dated December 14, 1995 ("Amendment No. 1").

<sup>5</sup>The components of the Index are: Chrysler Corporation Holding Co. ("C"); Dana Corp. ("DCN"); Echlin Inc. ("ECH"); Eaton Corp. ("ETN"); Ford Motor Co. ("F"); General Motors Corp. ("GM"); Genuine Parts Co. ("GPC"); Goodyear Tire and Rubber Co. ("GT"); Magna International Inc. ("MGA"); and TRW Inc. ("TRW").

<sup>6</sup>LEAPS is an acronym for Long-Term Equity Anticipation Securities. LEAPS are long-term index option series that expire from 12 to 36 months from their date of issuance. See CBOE Rule 24.9(b)(1).

<sup>7</sup>According to the CBOE, no proxy for the performance of this industry group is currently available in the U.S. exchange-traded derivatives markets, and the Exchange believes that options on the Index will provide investors with a low-cost means to participate in the performance of or to hedge the risk of investments in this sector.

<sup>8</sup>The Index portfolio is composed of ten components such that the largest capitalized Index

The average trading volume of the components of the Index, for the period from February 1, 1995, through July 31, 1995, ranged from a high of 3.53 million shares per day to a low of 135,738 shares per day.

### C. Maintenance

The Index will be maintained by CBOE. To maintain continuity in the Index following an adjustment to a component security, the divisor will be adjusted. Changes which may result in divisor changes include, but are not limited to, certain rights issuances, quarterly re-balancing, and component security changes. A component of the Index may be replaced in the event of certain events, such as a merger, consolidation, dissolution, or liquidation.

The Index is re-balanced after the close of business on Expiration Friday on the March Quarterly Cycle. In addition, the Index will be reviewed on approximately a monthly basis by the CBOE staff. The CBOE may change the composition of the Index at any time to reflect changes affecting the components of the Index or the Automotive industry generally. If it becomes necessary to remove a component from the Index, every effort will be made to add a component that preserves the character of the Index. Moreover, replacement securities must be "reported securities" as defined in Rule 11Aa3-1 of the Act.<sup>9</sup> In considering securities to be added to the Index, the CBOE will take into account the capitalization, liquidity, volatility, and name recognition of the proposed replacement component. CBOE will not decrease the number of components to less than 9 nor increase the number of components to more than 13.

If the number of stocks is increased, the weights will be redistributed such that the largest stock will never account for more than 25% of the weight of the Index and the top three stocks will not account for more than 50% of the weight of the Index and the remaining weight will be distributed among the remaining components to reflect the relative market value of those components. For example, if Stock XYZ is added and it is in the same market value range as those stocks with an 8.33% weight in the Index,<sup>10</sup> the

component (GM) represents 20% of the Index value, the second largest component (F) represents 17.5%, the third largest component (C) represents 12.5%, the fourth largest component (GT) represents 10%, the fifth (GT), sixth (TRW), and seventh (GPC) largest components each represent 8.33%, and the eighth (DCN), ninth (ECH), and tenth (MGA) largest components each represent 5%.

<sup>9</sup>See Amendment No. 1 *supra* note 4.

<sup>10</sup>See *supra* note 8.

following may be the result of the re-balancing: (1) GM—20%; (2) F—17.5%; (3) C—12.5%; (4) GT—10%; (5) TRW—6.25%; (6) GPC—6.25%; (7) ETN—6.25%; (8) XYZ—6.25%; (9) DCN—5%; (10) ECH—5%; and (11) MGA—5%.

If the number of stocks in the Index is decreased to 9, the largest stock will have a weight of no more than 25% of the Index and the top three stocks will account for no more than 55% of the Index. The remaining weight will be reallocated among the remaining components.

If it becomes necessary to replace a component security intra-quarter, the replacement security will be added at the same weight as the security being removed.<sup>11</sup> If a stock is replaced at the time of a quarterly re-balancing, the components will be ranked according to market value and the weighting methodology currently in use at the time of the replacement will be applied.<sup>12</sup> The number of component stocks in the Index will only be changed at the time of a quarterly re-balancing.

Prior to making any of the above changes to the Automotive Index, CBOE will notify members and member firms of the changes. Generally, these changes are sent by facsimile to member firms and distributed on the trading floor approximately one week prior to the change.<sup>13</sup>

Additionally, at each quarterly re-balancing, the Exchange will ensure that at least 80% of the number of components, and at least 90% of the weight of the Index satisfies the initial listing criteria in CBOE Rule 5.3<sup>14</sup> (for components which are not the subject of

<sup>11</sup>In the event that it becomes necessary to remove General Motors Corp., Ford Motor Co., or Chrysler Corporation, CBOE would most likely re-balance the Index at the time of the component change. The weighting of the Index would be reallocated depending on the market value of the replacement security. See Amendment No. 1, *supra* note 4.

<sup>12</sup>See Amendment No. 1, *supra* note 4. According to CBOE, the Index components will always be ranked in descending market capitalization order and the Index portfolio adjusted in accordance with the maintenance standards set forth herein. Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on December 14, 1995.

<sup>13</sup>See Amendment No. 1, *supra* note 4.

<sup>14</sup>The CBOE's options listing standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 7,000,000 shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume in the U.S. must have been at least 2.4 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$7.50 for a majority of the business days during the preceding three calendar months. See CBOE Rule 5.3, Interpretation and Policy .01.

standardized options trading) or the maintenance criteria in CBOE Rule 5.4<sup>15</sup> (for components which are currently the subject of standardized options trading).

The CBOE will promptly notify the Commission staff at any time that the CBOE determines that the Index fails to satisfy any of the above maintenance criteria. Further, in such an event, the Exchange will not open for trading any additional series of Index options or Index LEAPS unless the Exchange determines that such failure is not significant, and the Commission staff affirmatively concurs in that determination, or unless the Commission specifically approves the continued listing of that class of Index options or Index LEAPS pursuant to a proposal filed in accordance with Section 19(b)(2) of the Act.

#### *D. Applicability of CBOE Rules Regarding Index Options*

Except as modified by this order, the rules in Chapter XXIV of the CBOE Rules will be applicable to Index options and full-value and reduced-value Index LEAPS. In accordance with Chapter XXIV of CBOE's rules, the Index will be treated as a narrow-based index for purposes of applicable position and exercise limits, policies regarding trading halts and suspensions,<sup>16</sup> and margin treatment.<sup>17</sup>

#### *E. Calculation of the Index*

The Index will be calculated by CBOE or its designee on a real-time basis using last-sale prices. The value of the Index will be calculated continuously and will be disseminated to the Options Price Reporting Authority ("OPRA") every fifteen seconds by the CBOE, based on the last-sale prices of the securities comprising the Index. OPRA, in turn, will disseminate the Index value to other financial vendors such as Reuters, Telerate, and Quotron.<sup>18</sup> If a component security is not currently being traded on its primary market, the most recent

<sup>15</sup> The CBOE's options maintenance standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) The public float must be at least 6,300,000 shares; (2) there must be a minimum of 1,600 stockholders; (3) trading volume in the U.S. must have been at least 1.8 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$5.00 for a majority of the business days during the preceding six calendar months. See CBOE Rule 5.3, Interpretation and Policy .01.

<sup>16</sup> See CBOE Rule 24.7.

<sup>17</sup> See CBOE Rule 24.11.

<sup>18</sup> Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on October 31, 1995.

price at which the security traded on such market will be used in the Index calculation.

The Index is calculated on a "modified equal-dollar-weighted" method. The value of the Index equals the current combined market value (based on U.S. primary market prices) of the assigned number of shares of each of the components in the Index divided by the current Index divisor. The Index divisor was initially calculated to yield a benchmark value of 150.00 at the close of trading on December 16, 1994. The value of the Index at the close on July 31, 1995, was 179.93.

Each of the ten component securities is represented in dollar amounts that approximate the relative sizes of the companies in the Index. The Exchange believes that this methodology will present a fair representation of the automotive industry without assigning excessive weight to the top three securities (GM, F, and C), as measured by market capitalization. The initial component weights, and the weights at the time of the last quarterly re-balancing on June 16, 1995, were: GM—20%, F—17.5%, C—12.5%, GT—10%, ETN—8.33%, GPC—8.33%, TRW—8.33%, DCN—5%, ECH—5%, and MGA—5%.

The number of shares of each component security in the Index will remain fixed between quarterly reviews except in the event of certain types of corporate actions, such as the payment of a dividend (other than an ordinary cash dividend), stock distributions, stock splits, reverse stock splits, rights offerings, or a distribution, reorganization, recapitalization, or some such similar event with respect to an Index component. When the Index is adjusted between quarterly reviews, the number of shares of the relevant component in the portfolio will be adjusted, to the nearest whole share, to maintain the component's relative weight in the Index at the level immediately prior to the corporate action. In the event of a replacement, the average dollar value of the remaining portfolio components will be calculated and that amount invested in the new component stock, to the nearest whole share. In both cases, the divisor will be adjusted, if necessary, to ensure continuity in the value of the Index.<sup>19</sup>

The Index value for purposes of settling outstanding regular Index options and full-value and reduced-value Index LEAPS contracts upon

<sup>19</sup> Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on October 31, 1995.

expiration will be calculated based upon the regular way opening sale prices for each of the securities comprising the Index in their primary market on the last trading day prior to expiration.<sup>20</sup> In the event that a security traded as a Nasdaq/NM security is added to the Index, the first reported sale price for those shares will be used for determining a settlement value. Once the shares of all of the component securities represented in the Index have opened for trading, the value of the Index will be determined and that value will be used as the final settlement value for expiring Index options contracts, including full-value and reduced-value Index LEAPS. If any of the components of the Index do not open for trading on the last trading day before expiration, then the prior trading day's (i.e., normally Thursday's) last sale price will be used in the Index value calculation. In this regard, before deciding to use Thursday's closing value for a security contained in the Index for purposes of determining the settlement value of the Index, the CBOE will wait until the end of the trading day on Expiration Friday (as defined herein).<sup>21</sup>

#### *F. Contract Specifications*

The proposed options on the Index will be cash-settled, European-style options.<sup>22</sup> The trading hours applicable to the Index options will be from 8:30 a.m. to 3:10 p.m., Chicago time. The Index multiplier will be \$100. The strike price interval will be \$5.00 for full-value Index options with a duration of one year or less to expiration.<sup>23</sup> In addition, pursuant to CBOE Rule 24.9, there may be up to six expiration months outstanding at any given time. Specifically, there may be up to three expiration months from the March, June, September, and December cycle plus up to three additional near-term months so that the two nearest term months will always be available. As described in more detail below, the Exchange also intends to list several Index LEAPS series that expire from 12 to 36 months from the date of issuance.

Lastly, the options on the Index will expire on the Saturday following the third Friday of the expiration month

<sup>20</sup> As noted above, each of the component securities currently trade on the NYSE.

<sup>21</sup> Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on October 31, 1995.

<sup>22</sup> A European-style option can be exercised only during a specified period before the option expires.

<sup>23</sup> For a description of the strike price intervals for reduced-value Index options and long-term Index options, see *infra*, Section II.G.

("Expiration Friday"). Accordingly, because options on the Index will settle based upon opening prices of the securities comprising the Index on the last trading day before expiration (normally Expiration Friday), the last trading day for an expiring Index option series will normally be the second to the last business day before expiration (normally a Thursday).

#### *G. Listing of Long-Term Options on the Full-Value or Reduced-Value Automotive Index*

The proposal provides that the Exchange may list long-term Index options that expire from 12 to 36 months from listing based on the full-value Index or a reduced-value Index that will be computed at one-tenth of the full-value Automotive Index. Existing Exchange requirements applicable to full-value Index options will apply to full-value and reduced-value Index LEAPS.<sup>24</sup> The current and closing Index value for reduced-value Automotive Index LEAPS will be computed by dividing the value of the full-value Index by 10 and rounding the resulting figure to the nearest one-hundredth. For example, an Index value of 179.66 would be 17.97 for the reduced-value Index LEAPS and an Index value of 179.64 would be 17.96 for the reduced-value Index LEAPS. The reduced-value Index LEAPS will also be European-style and will be subject to the same rules that govern the trading of Index options, including sales practice rules, margin requirements and floor trading procedures. Pursuant to CBOE Rule 24.9, the strike price interval for the reduced-value Index LEAPS will be no less than \$2.50 instead of \$5.00.

#### *H. Position and Exercise Limits, Margin Requirements, and Trading Halts*

Exchange rules governing margin requirements,<sup>25</sup> position and exercise limits,<sup>26</sup> and trading halt procedures<sup>27</sup>

that are applicable to the trading of narrow-based index options will apply to options traded on the Index. The proposal further provides that, for purposes of determining whether given positions in full-value and reduced-value Index LEAPS comply with applicable position and exercise limits, positions in full-value and reduced-value Index LEAPS will be aggregated with positions in the regular Index options. For these purposes, ten reduced-value contracts will equal one full-value contract.

#### *I. Surveillance*

Surveillance procedures currently used to monitor trading in each of the Exchange's other index options will also be used to monitor trading in regular Index options and in full-value and reduced-value Index LEAPS. These procedures include complete access to trading activity in the shares of the securities comprising the Index. Further, the Intermarket Surveillance Group Agreement will be applicable to the trading of options on the Index.<sup>28</sup>

#### III. Findings and Conclusions

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, the requirements of Section 6(b)(5).<sup>29</sup> Specifically, the Commission finds that the trading of Automotive Index options, including full-value and reduced-value Index LEAPS, will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with a means of hedging exposure to market risk associated with

the automotive industry.<sup>30</sup> The trading of options on the Automotive Index, including full-value and reduced-value Index LEAPS, however, raises several issues related to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the CBOE has adequately addressed these issues.

#### *A. Index Design and Structure*

The Commission finds that the Automotive Index is a narrow-based index, because it is only composed of ten stocks, all of which are within the automotive industry. The Commission also finds that the reduced-value Automotive Index is also narrow-based because it is composed of same component securities as the Automotive Index and merely dividing the Index value by ten will not alter that basic character of the Index. Accordingly the Commission believes it is appropriate for the CBOE to apply its rules governing narrow-based index options to trading in the Index options and Index LEAPS.<sup>31</sup>

The Commission also finds that the large capitalizations, liquid markets, and relative weightings of the individual securities comprising the Index minimize the potential for manipulation of the Index. First, the securities comprising the Index are actively traded, with an average daily trading volume for all components for the period from February 1, 1995 through July 31, 1995, of approximately 10.91 million shares per day. Second, the market capitalizations of the components of the Index are large, ranging from a high of \$36.4 billion to a low of \$2.3 billion as of July 31, 1995, with the mean and median being \$11.23 billion and \$4.74 billion, respectively. Third, although the Index is composed of only 10 securities, no particular component security or group of securities dominates the Index. Specifically, as of June 16, 1995, no component security contained in the Index accounted for more than 20% of

<sup>30</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option proposal upon a finding that the introduction of such new derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument that served no hedging or other economic function because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed Index options and full-value and reduced-value Index LEAPS will provide investors with a hedging vehicle that should reflect the overall movement of automotive industry securities.

<sup>31</sup> See *supra* Section II.H.

<sup>24</sup> See CBOE Rule 24.9(b).

<sup>25</sup> Pursuant to CBOE Rule 24.11, the margin requirements for the Index options will be: (1) For short options positions, 100 percent of the current market value of the options contract plus 20 percent of the underlying aggregate Index value, less any out-of-the-money amount, with a minimum requirement of the options premium plus 10 percent of the underlying Index value; and (2) for long options positions, 100 percent of the options premium paid.

<sup>26</sup> Pursuant to CBOE Rules 24.4A and 24.5, respectively, the position and exercise limits for the Index options will be 9,000 contracts, unless the Exchange determines, pursuant to such rules, that a lower limit is warranted.

<sup>27</sup> Pursuant to CBOE rule 24.7, the trading on the CBOE of Index options and Index LEAPS may be halted or suspended whenever trading in component securities whose weighted value represents more than 20 percent of the Index value are halted or suspended.

<sup>28</sup> The Intermarket Surveillance Group ("ISG") was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. See Intermarket Surveillance Group Agreement, July 14, 1983. The most recent amendment to the ISG Agreement, which incorporates the original agreement and all amendments made thereafter, was signed by ISG members on January 29, 1990. See Second amendment to the Intermarket Surveillance Group Agreement, January 29, 1990. The members of the ISG are: the Amex; the Boston Stock Exchange, Inc.; the CBOE; the Chicago Stock Exchange, Inc.; the National Association of Securities Dealers, Inc. ("NASD"); the NYSE; the Pacific Stock Exchange, Inc.; and the Philadelphia Stock Exchange, Inc. Because of potential opportunities for trading abuses involving stock index futures, stock options, and the underlying stock and the need for greater sharing of surveillance information for these potential intermarket trading abuses, the major stock index futures exchanges (e.g., the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

<sup>29</sup> 15 U.S.C. 78f(b)(5).

the Index's total value and the five highest weighted securities in the Index accounted for 68.33% of the Index's value.

Fourth, the proposed maintenance criteria will serve to ensure that: (1) The Index remains composed substantially of liquid, highly capitalized securities; and (2) the Index is not dominated by any one security that does not satisfy the Exchange's options listing criteria. Specifically, in considering changes to the composition of the Index, 90% of the weight of the Index and 80% of the number of components in the Index must comply with the listing criteria for standardized options trading set forth in CBOE Rule 5.3 (for securities that are not then the subject of standardized options trading) and CBOE Rule 5.4 (for securities that are then the subject of standardized options trading).<sup>32</sup> Additionally, the CBOE is required to review the composition of the Index at least quarterly to ensure that the Index continues to meet this 90%/80% criterion.

The CBOE will promptly notify the Commission staff at any time that the CBOE determines that the Index fails to satisfy any of the above maintenance criteria. Further, in such an event, the Exchange will not open for trading any additional series of Index options or Index LEAPS unless the Exchange determines that such failure is not significant, and the Commission staff affirmatively concurs in that determination, or unless the Commission specifically approves the continued listing of that class of Index options or Index LEAPS pursuant to a proposal filed in accordance with Section 19(b) of the Act.

For the above reasons, the Commission believes that these criteria minimize the potential for manipulation of the Index and eliminate domination concerns.

#### B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as Automotive Index options, including full-value and reduced-value Automotive Index LEAPS, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an

<sup>32</sup> Additionally, the securities contained in the Index must be "reported" securities and must be traded on the Amex or the NYSE or must be Nasdaq/NM securities. See also *supra* notes 9-15 and accompanying text discussing certain requirements involving changes in the Index.

environment that is designed to ensure, among other things, that: (1) The special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index options and Index LEAPS will be subject to the same regulatory regime as the other standardized index options currently traded on the CBOE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in Automotive Index options and full-value and reduced-value Automotive Index LEAPS.

#### C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation.<sup>33</sup> In this regard, the Commission notes that the NYSE, which currently is the primary market for all of the Index's component securities, is a member of the ISG.<sup>34</sup> The Commission believes that this arrangement ensures the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the Index options and full-value and reduced-value Index LEAPS less readily susceptible to manipulation.<sup>35</sup>

#### D. Market Impact

The Commission believes that the listing and trading on the CBOE of Automotive Index options, including full-value and reduced-value Index LEAPS, will not adversely impact the markets for the securities contained in the Index.<sup>36</sup> First, because of the

<sup>33</sup> See Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992).

<sup>34</sup> See *supra* note 28.

<sup>35</sup> See *e.g.*, Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992) (order approving the listing of index options and index LEAPS on the CBOE Biotech Index).

<sup>36</sup> In addition, the CBOE has represented that the CBOE and the OPRA have the necessary systems capacity to support those new series of index options that would result from the introduction of

"modified equal-dollar-weighting" formula described above, no one security or group of securities represented in the Index will dominate the weight of the Index immediately following a quarterly re-balancing. Second, the maintenance criteria for the Index ensure that the Index will be substantially comprised of securities that satisfy the Exchange's listing standards for standardized options trading. Third, because the securities comprising the Index must be "reported securities" as defined in Rule 11Aa3-1 of the Act, the components of the Index generally will be actively-traded and highly-capitalized. Fourth, the 9,000 contract position and exercise limits applicable to Index options and Index LEAPS will serve to minimize potential manipulation and market impact concerns.

Lastly, the Commission believes that settling expiring Automotive Index options, including full-value and reduced-value Index LEAPS, based on the opening prices of the component securities is consistent with the Act.

The Commission finds good cause for approving Amendment No. 1 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. Specifically, Amendment No. 1 provides objective maintenance criteria which, for the reasons stated above, minimize the potential for manipulation of the Index and the securities comprising the Index. Further, as discussed above, the Commission believes that these maintenance criteria significantly strengthen the customer protection and surveillance aspects of the proposal, as originally proposed.<sup>37</sup>

Based on the above, the Commission finds good cause for approving Amendment No. 1 to the proposed rule change on an accelerated basis and believes that the proposal, as amended, is consistent with sections 6(b)(5) and 19(b)(2) of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1. 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

Index options and Index LEAPS. See Memorandum from Joe Corrigan, Executive Director, OPRA, to William Speth, CBOE, dated August 30, 1995.

<sup>37</sup> See *supra* note III.A.

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 Section, 450 Fifth Street, N.W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to the File Number SR-CBOE-95-51 and should be submitted by January 19, 1996.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>38</sup> that the proposed rule change (SR-CBOE-95-51), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>39</sup>

Margaret H. McFarland,  
Deputy Secretary.

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[Release No. 34-36622; File No. SR-PSE-95-27]

**Self-Regulatory Organizations; Pacific Stock Exchange, Incorporated; Order Granting Approval to Proposed Rule Change Relating to the Amendment of Its Minor Rule Plan To Include Certain Rules on Financial Reporting and Cooperation in Exchange Investigations and the Establishment of a Charge for the Late Filing of Periodic FOCUS Reports**

December 21, 1995.

On October 17, 1995, the Pacific Stock Exchange, Incorporated ("PSE" or "Exchange") submitted to the Securities and Exchange Commission ("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 to amend its Minor Rule Plan to include certain rules on financial reporting and cooperation in Exchange investigations and to establish an administrative charge for the late filing of quarterly FOCUS Reports.

The proposed rule change was published for comment in Securities Exchange Act Release No. 36474 (November 9, 1995), 60 FR 57611

(November 16, 1995). No comments were received on the proposal.

The Exchange's Minor Rule Plan ("MRP"), set forth in PSE Rule 10.13, provides that the Exchange may impose a fine not to exceed \$5,000 on any member, member organization, or person associated with a member or member organization, for any violation of an Exchange rule that has been deemed to be minor in nature and approved by the Commission for inclusion in the MRP. PSE Rule 10.13, subsections (h)-(j), sets forth the specific Exchange rules deemed to be minor in nature.

The Exchange is proposing to add the following provision to the MRP as PSE Rule 10.13(j)(5): "Failure to file a financial report or financial information in the type, form, manner and time prescribed by the Exchange. (Rule 2.12(a))."<sup>3</sup> The Exchange is also proposing to amend its Recommended Fine Schedule for rules listed in the MRP to establish the following recommended fines for violations of PSE Rule 2.12(a): \$100 for a first-time violation; \$250 for a second-time violation; and \$500 for a third-time violation.<sup>4</sup>

The Exchange is also proposing to add the following provision to the MRP as PSE Rule 10.13(j)(6): "Delaying, impeding or failing to cooperate in an Exchange investigation. (Rule 10.2(b))." The Exchange is also proposing to amend its Recommended Fine Schedule for rules listed in the MRP to establish the following recommended fines for violations of PSE Rule 10.2(b): \$100 for a first-time violation; \$250 for a second-time violation; and \$500 for a third-time violation.

In addition, the Exchange is proposing to amend PSE Rule 2.12(b)(1) to establish an administrative charge for member organizations that are late in filing their periodic FOCUS Reports

<sup>3</sup> PSE Rule 2.12(a) states: "Every member organization which is not a member of another national securities exchange or registered national securities association which is the Designated Examining Authority for that member organization shall file with the Exchange answers to Financial Questionnaires, Reports of Income and Expenses and additional financial information in the type, form, manner and time prescribed by the Exchange."

The Exchange stated that Rule 2.12(a) does not encompass the filing with the Exchange of either periodic or annual FOCUS Reports required by SEC Rules 17a-5 or 17a-10. Telephone conversation between Michael D. Pierson, Senior Attorney, PSE, and Jon Kroeper, Attorney, SEC, on December 19, 1995.

<sup>4</sup> For a discussion of the Exchange's Recommended Fine Schedule, see Securities Exchange Act Release No. 34322 (July 6, 1994), 59 FR 35958 (July 14, 1994).

with the Exchange.<sup>5</sup> The proposed rule change would add a reference to Rule 17a-5 to the text of PSE Rule 2.12(b)(1), making the late filing of periodic FOCUS Reports subject to the same "late charge" schedule that currently applies to the late filing of annual FOCUS Reports required by Rule 17a-10 under the Act.<sup>6</sup>

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 Section 6(b).<sup>7</sup> In particular, the Commission believes the proposal is consistent with the Section 6(b)(5) requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public, and with the Section 6(b)(6) requirement that the rules of an exchange provide that its members be appropriately disciplined for violations of an exchange's rules and the Act.

Specifically, the Commission believes that adding the above-listed provisions to the Exchange's MRP is consistent with Sections 6(b)(5) and 6(b)(6) in that the purpose of the Exchange's MRP is to provide for a response to a violation of Exchange rules when a meaningful sanction is needed, but when initiation of a formal disciplinary proceeding pursuant to PSE Rule 10.3<sup>8</sup> is not suitable because such a proceeding would be more costly and time-consuming than would be warranted

<sup>5</sup> The Exchange's Plan filed pursuant to Rule 17a-5(a)(4) under the Act requires PSE member organizations that are not exempt from Rule 15c3-1 under the Act ("Net Capital Rule") to file periodic FOCUS Reports with the Exchange if the PSE is their designated examining authority ("DEA"). See 17 CFR 240.17a-5(a)(4); Securities Exchange Act Release No. 11935 (December 17, 1975), 40 FR 59706 (December 30, 1975) (order approving the PSE's Plan pursuant to Rule 17a-5). In 1993, the SEC approved certain changes to the Net Capital Rule, including the elimination of an exemption for certain equity exchange specialists, effective as of April 1, 1994. See Securities Exchange Act Release No. 32737 (August 11, 1993), 58 FR 43555 (August 17, 1993). Consequently, as of April 1, 1994, a number of Exchange specialists became obligated to file FOCUS reports with the Exchange. Prior to April 1994, no PSE member organizations were required to file such reports with the Exchange.

<sup>6</sup> 17 CFR 240.17a-10. The current "late charge" schedule found in PSE Rule 2.12(b)(1) is as follows: 1-30 days later—\$200; 31-60 days late—\$400; 61-90 days late—\$800. Any failure to file an annual FOCUS Report longer than 90 days is referred to the Ethics and Business Conduct Committee for appropriate disciplinary action.

<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> PSE Rule 10.3 governs the initiation of formal disciplinary proceedings by the Exchange for violations within the disciplinary jurisdiction of the Exchange

<sup>38</sup> 15 U.S.C. 78s(b)(2).

<sup>39</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.