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 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 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 USC § 552, will be available for inspection and copying at the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR–CBOE–97–11 and should be submitted by May 15, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–38519; File No. SR–Phlx–96–38]

Self-Regulatory Organizations; Notice of Filing of Amendment No. 1 to Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Respecting FLEX Equity and Index Options

April 17, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on March 6, 1997, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') Amendment No. 1 to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The proposed rule change, as originally filed, was published in the **Federal Register** on September 24, 1996.[1] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Phlx, pursuant to Rule 19b–4 of the Act, proposes to amend its proposal[2] to adopt Rule 1079, Index and Equity FLEX[3] Options, which would govern the trading of customized or flexible (''FLEX'') index and equity options on the Exchange, as follows: (1) Customization of equity FLEX option strike prices for calls will not be permitted; (2) regardless of the specific parity/priority provisions for assigned Registered Options Traders (''ROTs'')/Specialists, all FLEX transactions must be in compliance with Section 11(a) of the Act; (3) clarify that once a FLEX option is quoted, the Request-for-Quote (''RFQ'') remains open that day unless a trade occurs, replacing the concept of ''markets remaining open;'' (4) the provision that the executing member has priority over other members seeking to trade with a booked order would be deleted; (5) FLEX trading hours, although currently established as 10 a.m. to 4:10/4:15 p.m., could be changed to any time within regular non-FLEX trading hours; (6) increase the industry (narrow-based) index options position and exercise limits; (7) add an introductory paragraph and reference to Rule 1079 to Floor Procedure Advice (''Advice'') F–28; (8) exclude solicited orders and broker-dealer crosses from the 25% minimum guaranteed right of participation for crossing transactions; (9) utilize the current reporting authority for calculating FLEX index values; (10) designate all Phlx index options as eligible for FLEX options, subject to Options Committee approval; (11) determine the best market at the end of the response time based on price; and (12) adopt a $1,000,000 net capital requirement for index FLEX specialists. This amendment also restates the original proposal. In the original proposal, the Exchange had proposed to trade FLEX options on specific Phlx index options. At this time, the Exchange proposes to designate all Phlx index options as eligible for FLEX options trading, subject to Options Committee approval.[4] Thus, the Phlx is proposing to trade FLEX options on industry (narrow-based) index options pursuant to the proposed rule, in addition to market (broad-based) index options. Further, the Phlx is proposing to trade equity FLEX options on securities which are options-eligible pursuant to Rule 1009, with the Options Committee designating the specific issues.

Proposed rule 1079 contains the characteristics, trading procedure and other provisions applicable to trading FLEX ™[3] options. All FLEX options must be quoted and traded in the trading crowd of the corresponding non-FLEX option. The Exchange notes that the Automated Options Market (''AUTOM'') system will not be available for FLEX options. Proposed Rule 1079 also states that although FLEX options are generally subject to the rules in the options section,[5] to the extent that the provisions of Rule 1079 are inconsistent with other applicable Exchange rules, Rule 1079 takes

[1] *See* Securities Exchange Act Release No. 37691 (September 17, 1996), 61 FR 50060.

[2] The original proposal was published for comment in Securities Exchange Act Release No. 37691 (September 17, 1996) (File No. SR–Phlx–96–38).

[3] The term ''FLEX'' is a trademark of the Chicago Board Options Exchange, Inc. (''CBOE'').

[4] The following are the current Phlx market index options: Value Line Composite Index (''VLE''), National Over-the-Counter Index (''XOC''), and U.S. Top 100 Index (''TPX''). The following are the current Phlx industry index options: OTC Industrial Average Index (''OTZ''), Bank Index (''BKK''), Gold/Silver Index (''XAU''), Semiconductor Index (''SOX'') and Utility Index (''UTY''), Forest and Paper (''FPP''), Plane (''PLN''), Phone (''PNX''), and Oil Service (''OSX''). Because the Super Cap Index (''HFX'') is neither a market or and industry index, the Exchange applies a position limit of 5,500 contracts for the non-FLEX overlying option. This position limit is lower than the position limit tiers for standardized non-FLEX industry index options.

[5] *See* Phlx Rules 1000, et. seq.

precedence with respect to FLEX options.

Because FLEX options would not be continuously quoted, nor are series pre-established, the variable terms of FLEX options shall be established by the following process. In order to initiate a transaction, a Requesting Member must submit an RFQ to the appropriate trading crowd, announcing the terms of the quote sought. The characteristics, including which terms and to what degree customization will be available, are outlined in Rule 1079(a).[6] For example, the exercise strike price respecting index FLEX options can be specified at the time the quote is requested in terms of a specific index value number (*e.g.*, 553.5), a method for fixing such number (*e.g.*, 10 basis points over the index value at a certain time, or with the future trading at a certain price), or a percentage of index value calculated as of the open or close of trading on the Exchange on the trade date (*e.g.*, 5% above the close).[7] Similarly respecting equity FLEX options, the exercise strike price can be specified in terms of a specific dollar amount rounded to the nearest one-eighth of a dollar, or a percentage of the underlying security rounded to the nearest tick. However, the Exchange proposes to amend its original proposal to state that customization of equity FLEX option strike prices for calls will not be permitted; only strikes that may be listed pursuant to Rule 1012 are eligible, such that the strike price must be consistent with strike price intervals permissible for equity options.[8]

The exercise style can be either American or European,[9] regardless of the exercise style of the listed option.[10] The expiration date can also be customized, specifying any business day (non-holiday)—any month, day and year within five years for index flex options and three years for equity FLEX options. However, FLEX options may not expire on any day that falls on or within two business days of (prior or subsequent to) a mid-month expiration day for a non-FLEX option on the same underlying index or security (other than a quarterly expiring index option[11]). In addition, a FLEX option cannot expire on the same day that series is established at OCC.[12]

With respect to the minimum size of *market index* FLEX option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is $10 million underlying equivalent value; if there is open interest, the minimum value size of an RFQ is $1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less. The underlying equivalent value is defined as the aggregate underlying value of an index FLEX option (index multiplier times the current index value) multiplied by the number of index FLEX options. The minimum value size for a responsive quote is market index FLEX options is $1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less.

With respect to the minimum size of industry index FLEX option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is $5 million underlying equivalent value; this amount is one-half of the minimum size proposed by the Phlx and currently in place on other options exchanges for flexible broad-based index options. Where there is open interest, the minimum value size of an RFQ is $1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less. The minimum value size for a responsive quote is $1 million underlying equivalent value, or the remaining underlying equivalent value on a closing transaction, whichever is less.

With respect to the minimum size of equity FLEX option quotes, if there is no open interest in the particular series when an RFQ is submitted, the minimum value size of an RFQ is 250 contracts; if there is open interest, the minimum value size of an RFQ is 100 contracts, or the remaining size on a closing transaction, whichever is less. The minimum value size for a responsive quote in equity FLEX options is 100 contracts, or the remaining size on a closing transaction, whichever is less.

Despite the aforementioned minimum size requirements, assigned ROTs and an assigned Specialist are required to respond to each RFQ with a certain minimum size. Respecting broad-based index FLEX options, assigned ROTs and the assigned Specialist are each required to respond with at least $10 million underlying equivalent value or the dollar amount requested in the RFQ, whichever is less. Respecting narrow-based index FLEX options, assigned ROTs and an assigned Specialist are each required to respond with at least $5 million underlying equivalent value or the dollar amount requested in the RFQ, whichever is less. Respecting equity FLEX options, assigned ROTs and the assigned Specialist are each required to respond with a market of at least 250 contracts or the dollar amount requested in the RFQ, whichever is less.

The settlement value for index FLEX options may be specified as the value reported on the Exchange at the: (i) Close of trading (P.M.-settled), (ii) opening of trading (A.M.-settled), or (iii) as an average over a specified period of time, within parameters established by the Exchange.[13] For example, the third category includes the average of the index's opening and closing settlement values on the expiration date, the average of the index's high and low values on the expiration date, or the average of the index's opening, closing, high and low values on the expiration date. However, American style index FLEX options exercised prior to the expiration date can only settle based on the closing value on the exercise date.[14] Index FLEX options may be designated for settlement in U.S. dollars, British pounds, Canadian dollars, Deutsche marks, European Currency Units, French francs, Japanese yen or Swiss francs. With respect to the settlement process applicable to equity FLEX options, exercise settlement shall be by physical delivery of the underlying security pursuant to Rule 1044. Also, equity FLEX options will be subject to

[6] Rule 1079 generally parallels the provisions of Rule 1069 governing foreign currency options.

[7] Initially, the exercise strike price will not be available for customization as a percentage, pending systems enhancements.

[8] *See* Rule 1012, Commentary .05.

[9] An American style option may be exercised at any time up to its expiration, while a European style option can only be exercised on its expiration day. *See* Phlx Rule 1000(b)(35).

[10] In certain circumstances, European style equity FLEX options may be adjusted to require the delivery upon exercise of a fixed amount of cash. *See* Options Clearing Corporation (''OCC'') By-Law, Article VI, Section 11, Interpretation and Policy .08.

[11] Quarterly expiring index options expire on the first business day of the month following the end of the calendar quarter.

[12] This provision replaces language in Rule 1079(a)(6)(C) of the original proposal stating that a new series cannot be opened on the day of exercise.

[13] The Exchange proposes to retain its existing securities information vendor as the reporting authority for FLEX index options, respecting any additional index value calculations required due to the type of customization offered by FLEX options. The Exchange is not proposing, at this time, to utilize its own Index Calculation Engine (''ICE'') System as the reporting authority for FLEX options. *See* Securities Exchange Act Release No. 38292 at n. 4. (February 14, 1997) (SR–Phlx–96–36).

[14] This limitation is currently in place on other exchanges trading FLEX options and with respect to other American style A.M.-settled index options. *See* Characteristics and Risks of Standardized Options Trading, February 1994, at page 48.

the exercise-by-exception procedures of OCC.[15]

With respect to the quote format of FLEX options, a bid and/or offer in the form of a specific dollar amount reflected as a fractional price (*e.g.*, ⅛, ¼), or a percentage of the underlying security or underlying equivalent value, rounded to the nearest minimum tick shall be acceptable. The option type may be a put, call or hedge order.[16]

The quoting and trading procedure for FLEX options, beginning with the RFQ, is enumerated in Rule 1079(b). Submitting an RFQ is the first step in quoting FLEX options. The Requesting Member must first announce the RFQ to the trading crowd of the non-FLEX option and then submit an RFQ ticket, containing the following: (1) Underlying index or security, (2) type, (3) exercise style, (4) expiration date, (5) exercise price, and, respecting index FLEX options, (6) settlement value (*e.g.*, A.M. or P.M.) and (7) the designated settlement currency. Thereafter, on receipt of an RFQ in proper form, the assigned Specialist or the Requesting Member shall cause the terms of the RFQ to be disseminated as an administrative text message through the Options Price Reporting Authority (''OPRA'').[17] RFQs, responsive quotes, booked orders and completed trades will be promptly reported to OPRA and disseminated as an administrative text message. The Exchange notes that although certain information is not required to be part of the RFQ (such as account type, crossing intention, response time and size), this information will be reflected on the final order ticket. Further, the size and crossing intention must be voiced as part of voicing the trade.

Following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes. As stated in paragraph (b)(2), the response time, between two and 15 minutes, will be determined by the Options Committee, which may depend on the complexity of the RFQ.[18] during the response time, qualified members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn during such response time.

At the end of the response time, the assigned Specialist, or if none, the Requesting Member shall determine the best bid and offer (''BBO''), based on price, disseminating such market with reference to the corresponding RFQ. However, where two or more bids/offers are at parity, priority will be afforded to bids/offers submitted by assigned ROTs/Specialists. The Exchange has also added language to the text of the proposed rule and Advice stating that all transactions must be in compliance with Section 11(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder.

Following the determination of the BBO, a BBO Improvement Interval may be invoked if the Requesting Member rejects the BBO or the BBO is for less than the entire size requested.[19] The BBO Improvement Interval is a two minute time period during which the BBO may be matched or improved. As a result of the Improvement Interval, a new BBO is established, which is disseminated with reference to the corresponding RFQ. An assigned ROT and the assigned Specialist who responded with a market during the response time may immediately join the new BBO.

A trade in FLEX options cannot be executed until the end of the response time or BBO Improvement Interval. Once the response time or BBO Improvement Interval ends, the Requesting Member is given the first opportunity to trade on the market by voicing a bid/offer in the trading crowd.[20] The Requesting Member has no obligation to accept any bid or offer for a FLEX option. If the Requesting Member rejects the BBO or the BBO size exceeds the entire size requested, another member may accept such BBO or the unfilled balance of the BBO. Acceptance of a bid/offer creates a binding contract under Exchange rules.

Once the BBO is established, the RFQ remains open that trading day, unless a trade occurs, and a member may re-quote the market with respect to the open RFQ without submitting an additional RFQ. If a trade occurs, a new RFQ is required. Only an assigned ROT or assigned Specialist who responded to the open RFQ during the response time or BBO Improvement Interval may immediately join the re-quoted market, thus matching for parity purposes. Neither the Requesting Member, nor the re-quoting member, is given the first opportunity to trade on the re-quoted market. Thus, replacing ''markets remaining open'' with the RFQ remaining open is another change from the original proposal.[21]

Further, there will be a limit order book for FLEX options. The Specialist in the listed non-FLEX equity or index option, whether or not assigned in FLEX options, must accept FLEX orders on the FLEX book after completion of the RFQ process. Only customer day limit orders may be placed on the index FLEX or equity FLEX option book. Booked orders expire at the end of each trading day. The limit price and size must be written on the RFQ ticket and disseminated as an administrative text message through OPRA. In order to trade with the book, an executing member must quote the market and announce the trade. The Exchange proposes to delete the provision that the executing member has priority over other members, including assigned ROTs and the assigned Specialist, seeking to trade with the booked order. The purpose of this change is to trade FLEX options off the book similarly to non-FLEX options, noting that this consistency should prevent confusion.

Generally, on the Phlx options floor, a cross may take place in accordance with Rule 1064. With respect to FLEX options, after the BBO has been determined, the Requesting Member intending to cross must bid (or offer) at or better than the BBO. Whenever a Requesting Member intends to cross, after the BBO is determined, with or without a BBO Improvement Interval, the Requesting Member must announce an intention to cross, and then bid and offer at or better than the BBO. If the Requesting Member's bid/offer is at the BBO, the Requesting Member may execute 25% or a fair split, whichever is greater, of the contraside of the order that is the subject of the RFQ. For instance, if there are two members on parity at the BBO, the Requesting Member and an assigned ROT, the Requesting Member is entitled to receive 50% of the contra-side contracts, which is a fair split, not just the 25%

[15] OCC Rule 805 provides for automatic exercise of in-the-money options at expiration without the submission of an exercise notice to OCC if the price of the security underlying the option is at or above a certain price (for calls) or at or below a certain price (for puts); and the non-exercise of an option at expiration if the price of the security underlying the option does not satisfy such price levels.

[16] *See* Rules 1000(b)(7) and 1066(f).

[17] Operationally, the Requesting Member provides this information to data entry personnel, who enter it into Exchange systems.

[18] Initially, the Options Committee has established a response time of ten minutes. Although this Committee will be authorized to change the response time within the permissible range, any such change will be preceded by notice to the Exchange membership. The Exchange believes that such a change does not require a filing with the Commission pursuant to Section 19(b). *See also* CBOE Rule 24A.4(a)(3)(iii).

[19] Once a BBO has been established at the end of the response time, if a member bids/offers, the BBO Improvement Interval is thus triggered.

[20] Thus, when a Requesting Member seeks to trade on the established BBO, an assigned ROT/Specialist cannot participate. For example, where the BBO is 6–7, if the Requesting Members seeks to sell 500 contracts at 6, the Requesting Member has priority for that purpose.

[21] Previously, the Exchange proposed to allow markets to remain open, but not be firm, such that members had to re-quote the market.

guaranteed minimum right of participation. The remainder of the contra-side is split in accordance with the parity/priority provision applicable to determining the BBO, such that assigned ROTs/Specialists may be afforded priority.

If the Requesting Member's bid/offer improves the existing BBO, an assigned ROT or assigned Specialist who responded with a market during the response time or BBO Improvement Interval, may immediately join the Requesting Member's improved bid or offer, thus matching for parity purposes. However, the Requesting Member may execute 25% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision applicable to determining the BBO, such that assigned ROTs/Specialists may be afforded priority. However, broker-dealer crosses and solicited orders, as defined in Rule 1064, are not eligible for the split afforded by these crossing provisions (sub-paragraphs (A) and (B)). Instead, such orders are, after the announcement of an intention to cross, executable in accordance with sub-paragraphs (5) and (6). Specifically, such orders must be announced and bid/offered, under the FLEX crossing provision. No 25% minimum guaranteed right of participation applies to solicited orders or broker-dealer/broker-dealer crosses.

The Exchange notes that an ROT and Specialist may trade FLEX options as an assigned ROT/Specialist or as a non-assigned ROT/Specialist. However, the FLEX assigned Specialist must be the specialist in the non-FLEX option. ROTs and Specialists must apply on the appropriate Exchange form to be assigned in FLEX options. An assigned ROT or assigned Specialist may choose to be assigned in a particular FLEX option, but must respond with a market respecting any FLEX option upon request by a Floor Official.

Assigned ROTs and the assigned Specialist will be subject to certain obligations respecting the trading of FLEX options. For example, the affirmative and negative market making obligations of Rule 1014(c) apply. Further, assigned ROTs and the assigned Specialist are required by paragraph (b)(ii) to respond with a market of the minimum size.[22] At least two ROTs and/or a Specialist shall be assigned to each FLEX option. If there is a Specialist, the FLEX option will trade pursuant to the specialist system, just as non-FLEX options currently do on the Exchange. If, however, there is no assigned Specialist in a FLEX option, two assigned ROTs are required for that FLEX option to trade.

Because of the minimum size obligations, assigned ROTs and the assigned Specialist are afforded priority over other bids/offers at parity during the response time. Further, assigned ROTs and the assigned Specialist who responded with a market during the response time may join a new bid/offer voiced during the Improvement Interval and prior to a cross, provided they do so immediately and subject to preserving the priority of customer orders. Enabling assigned ROTs and the assigned Specialist to join such new bid/offer affords them parity at that new BBO.

There will be no trading rotations in FLEX options, either at the opening or at the close of trading. The Exchange also amended the original proposal to state that FLEX options trading must be effected during the hours established by the Exchange. Such hours shall be within regular Exchange trading hours (for the non-FLEX option) on each business day, except that the Exchange in its discretion may determine at any time to narrow or expand FLEX trading hours to encompass, but not exceed, the trading hours of the non-FLEX option. Initially, unless otherwise determined by the Exchange, transactions in FLEX options may be effected each trading day from 10 AM to: (1) 4:15 PM respecting market index FLEX options; and (2) 4:10 PM respecting industry index FLEX and equity FLEX options.[23]

Generally, FLEX option positions are not taken into account when calculating position limits for non-FLEX options on the same index.[24] Accordingly, broad-based index FLEX options currently approved for non-FLEX options trading will be subject to a separate position limit of 200,000 contracts on the same side of the market.[25] Narrow-based index FLEX options will be subject to a position limit of four times the current position limit—36,000, 48,000 or 60,000 contracts on the same side of the market.[26] Respecting equity FLEX options, the position limit will be three times the current limit applicable to the listed equity option—75,000, 60,000, 31,500, 22,500 or 13,500 contracts on the same side of the market. The Exchange notes that both the market index FLEX option limits as well as the equity FLEX option limits are the same as the provisions of other exchanges.[27] The Exchange also believes that four times the non-FLEX limit is an appropriate limit for industry index FLEX options.[28]

A separate exercise limit would also apply, equivalent to the applicable position limit. The minimum exercise size would be the lesser of $1 million or the remaining size of the position respecting index options, and the lesser of 100 contracts or the remaining size of the position respecting equity options.

The proposal requires any ROT and Specialist to submit a Letter of Guarantee[29] issued by a clearing member organization, specifically accepting financial responsibility for all FLEX option transactions made by such person. Moreover, an assigned Specialist in FLEX index options shall be required to maintain a minimum of $1,000,000 in net capital. An assigned ROT in FLEX index options will be required to maintain a minimum of $100,000 in net liquid assets. Floor Brokers must maintain a minimum of $50,000 in net capital to qualify to trade FLEX options. Assigned ROTs, the assigned Specialist and Floor Brokers

[22] However, assigned ROTs and assigned Specialists are not required to provide continuous quotes or markets at a certain minimum bid-ask differential (quote spread parameter).

[23] The trading hours for options may change. FLEX trading will have to be within established trading hours for the non-FLEX product. *See e.g.*, SR–Phlx–97–04.

[24] However, positions in P.M.-settled customized index options shall be aggregated with positions in quarterly expiring options (''QIXs'') on the same index, *if* the customized option expires at the close of trading on or within two business days of the last trading day in a quarter. The Exchange is authorized to trade QIXs on certain index options pursuant to Rule 1101A(b)(iv), although none currently trade.

[25] The following are the current Phlx market (broad-based) index options: Value Line Composite Index (''VLE''), National Over-the-Counter Index (''XOC''), and U.S. Top 100 Index (''TPX''). If the Exchange wants to list and trade FLEX options on a broad-based index subsequently approved for non-FLEX options trading, the Exchange must submit a 19b–4 filing with the Commission proposing appropriate FLEX market index options position limits.

[26] The following are the current Phlx industry (narrow-based) index options: OTC Industrial Average Index (''OTZ''), Bank Index (''BKX''), Gold/Silver Index (''XAU''), Semiconductor Index (''SOX'') and Utility Index (''UTY''), Forest and Paper (''FPP''), Plane (''PLN''), Phone (''PNX''), and Oil Service (''OSX''). Because the Super Cap Index (''HFX'') is neither a market nor an industry index, the Exchange applies a position limit (5,500 contracts) that is lower than the position limit tiers for standardized non-FLEX industry index options. Accordingly, the position limit for FLEX options overlying the Super Cap Index will be 22,000 contracts (4 times 5,500 contracts—the existing non-FLEX position limit).

[27] *See e.g.*, CBOE Rule 24A.7(b).

[28] *See* Phlx Rule 1001A(b). In 1996, these limits were raised from 6,000, 9,000 or 12,000 contracts to 9,000, 12,000 or 15,000 contracts. Securities Exchange Act Release No. 37863 (October 24, 1996) (File No. SR–Phlx–96–33). Thus, the proposed change in the corresponding FLEX limits is a change from the original proposal reflecting four times the previous limits.

[29] *See* Phlx Rule 703.

must immediately notify the Exchange's Examinations Department upon failure to be in compliance with these requirements. The Exchange may waive the financial requirements of this Rule in unusual circumstances. Assigned Specialists/ROTs in FLEX equity options, as well as non-assigned ROTs/Specialists in FLEX options, are required to comply with Exchange financial requirements.[30]

The Exchange also proposes to adopt Floor Procedure Advice F–28, Trading Index and Equity FLEX Options, to parallel most of the provisions of Rule 1079(b), including those pertaining to requesting quotations, responses, determining the BBO, the BBO Improvement Interval, executing a trade and crossing. Advice F–28 is not proposed to contain a fine schedule, such that it does not require inclusion in the Exchange's minor rule violation enforcement and reporting plan. This amendment adds an introductory paragraph containing portions of Rule 1079(a) and (b), as well as a specific reference to Rule 1079.

II. Self-Regulatory Organization's Statements of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization 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 self-regulatory organization has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statement.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposal is to trade options with flexible characteristics in an exchange auction environment. The Phlx is specifically proposing to trade flexible index and equity options, with several different contract specifications available for customization, including the exercise price (except equity FLEX call options), exercise style, expiration date and method for determining the exercise settlement value.

The Exchange believes that flexible options will provide important trading opportunities, which may currently be unavailable due to pre-set expiration dates, exercise prices and exercise styles. For example, although the VLE is European style, a flexible VLE contract could be crafted pursuant to Rule 1079 as an American style option. Thus, customization offers new trading potential respecting existing securities.

Currently, there exists an active over-the-counter (''OTC'') market in options, where basic option features can be customized. Customizing option terms enables an investor to more closely tailor investment strategies to option products. These customized options are often trade by institutional investors with specific trading needs. In response, the Exchange seeks to trade FLEX options in an exchange auction market environment, with the OCC as issuer and guarantor.[31] Thus, FLEX options are structured with a minimum size reflecting the larger-sized trades of these institutional users.[32]

The proposed rule, Rule 1079, is based upon the Exchange's Rule 1069, Customized Foreign Currency Options, and Exchange experience with trading this product since November, 1994.[33] Generally, FLEX options shall be traded in accordance with many existing option and index option rules; however, Rule 1079 contains certain new trading procedures unique to FLEX options. In addition, the Exchange believes that the proposal is similar to the rules and proposals of other exchanges respecting flexible options.[34]

Several such common provisions are intended to ensure orderly trading. For example, the Exchange has determined that, initially, FLEX options will begin trading at 10 AM, one half hour after the normal opening of trading index options on the Exchange, in order to limit the burden on the trading crowd. Industry index and equity FLEX options will trade until 4:10 PM, to correspond to the non-FLEX option, similar to market index FLEX options, which would trade until 4:15 PM. The Exchange may establish other trading times within the regular trading hours for the non-FLEX option, including coordination with FLEX trading hours on other exchanges and reflecting new trading hours for non-FLEX options.[35]

As another example, the RFQ process, which allows a set period of time for bids and offers to be determined, is also designed to create an orderly trading environment, recognizing that greater variation in option terms requires sufficient time to respond with a quote. The response time and the BBO Improvement Interval should thus promote depth and liquidity as well.

In order to provide adequate liquidity in FLEX options, two assigned members, whether ROTs or Specialists, are required for each FLEX option, and must be present for a trade to occur.[36] In addition, the minimum size requirements are intended to attract depth and liquidity to FLEX options.

Other FLEX provisions are intended to minimize the market impact of this product. For one, the expiration date may not fall on or within two business days before or after the normal mid-month Friday expiration for options. Because the expiration date of FLEX options may not correspond to a non-FLEX expiration, FLEX options should not affect the market for the underlying security at the same time, thereby not placing added pressure on that security at the same time. This, in turn, minimizes the impact of FLEX options on the marketplace.

Second, position and exercise limits will apply to FLEX options, although separate from those applicable to non-FLEX options. The Exchange believes that separate, higher limits and non-aggregation are appropriate for FLEX options, which are intended to compete with OTC options that are not subject to such limits. The higher limits reflect the institutional nature and resulting larger size of FLEX options.

In order to enhance customer protection, certain financial standards will apply, including a capital requirement and a Letter of Guarantee from a clearing firm respecting FLEX options trading. The Exchange believes that the existence of separate position and exercise limits serves a customer protection function as well, by reducing systemic risk.

Although FLEX options are characterized by variable terms, not all

[30] *See* Phlx Rule 703.

[31] For a discussion of clearance and settlement procedure for FLEX options, *see* Securities Exchange Act Release No. 37318 (June 18, 1996) (SR–OCC–96–03). For example, OCC may depart from regular expiration date procedures and deadlines in the case of equity FLEX options, pursuant to OCC Rule 805, Interpretation and Policy .03.

[32] The Exchange notes that the Commission has previously designated index and equity FLEX options as standardized options for the purposes of the options disclosure framework established under Rule 9b–1 of the Act. *See* Securities Exchange Act Release No. 37824 (October 15, 1996).

[33] Securities Exchange Act Release No. 34925 (November 1, 1994) (SR–Phlx–94–18).

[34] *See, e.g.,* CBOE Rules 24A.1–24A.17; Amex Rules 900G, et. seq.; and PSE Rules 8.100–8.115.

[35] Under this proposal, the Exchange understands that expanding and narrowing FLEX trading hours within the regular trading hours of the particular product would not require a proposed rule change pursuant to Section 19(b) of the Act. The Exchange, however, will notify its members if any such change should be made.

[36] *See* Floor Procedure Advices A–10, Specialist Trading with Book, and C–1, Ascertaining the Presence of ROTs in Trading Crowd, which require that, in addition to the Specialist, an ROT be present during a transaction.

FLEX option terms can be customized. As stated above, the expiration date cannot fall on certain days. Customization of equity FLEX option strike prices for calls will not be permitted, due to tax issues arising out of the definition of a qualified covered call. Thus, only equity option call strikes that may be listed pursuant to Rule 1012 are eligible, such that the strike price must be consistent with strike price intervals permissible for equity options. In addition, American-style index FLEX options exercised prior to the expiration date can only settle based on the closing value on the exercise date. Despite these restrictions on customization,[37] the Phlx believes FLEX options should nevertheless address a market need for variation in contract terms.

Not only will FLEX options combine variable terms with an auction marketplace and OCC guarantee, but FLEX options will also offer transparency of quotes and trades, because the proposal requires prompt and complete quotation and transaction reporting. Although flexible options will not be continuously quoted, once an RFQ is received, its terms, as well as the responding quotes, will be disseminated by Exchange systems. The terms of any resulting trade will also be disseminated. Specifically, the assigned Specialist, or if none, the Requesting Member will ensure immediate dissemination to OPRA in the form of an administrative text message, which will, in turn, disseminate the information to subscribing vendors.

The Exchange expects to implement a separate computer system to handle index and equity FLEX options, similar to the system utilized for customized foreign currency options. The Exchange expects that initially FLEX options will be entered into this system at a limited number of locations on the trading floor, which will be described in detail by notice to the options trading floor.

The Exchange proposes to utilize a limit order book for FLEX option orders resulting from the RFQ process. The purpose of the book is to accommodate customers who have specified a limit price for a FLEX option order that is away from the market established during the RFQ process. The limit order book will be limited to customer day limit orders, which must be accepted by the Specialist, whether or not that Specialist is assigned in FLEX options. As such, the Specialist must monitor FLEX markets for any booked orders. The Exchange is requiring all Specialists, whether acting as an assigned FLEX Specialist or not, to maintain a FLEX book for consistency with the procedures for non-FLEX options and to prevent investor confusion. The Exchange believes that the FLEX order book should serve as a useful tool for customers, as does the current limit order book respecting non-FLEX options. With respect to booked orders for the same FLEX option (identical terms), Rule 1014 will apply to determine priority and parity among such orders.[38] When trading with a booked order, a member must re-quote the market and announce the trade.

The Exchange proposes to delete the provision in the original proposal that the executing member has priority over other members, including assigned ROTs and the assigned Specialist, seeking to trade with the booked order. The purpose of this change is to trade booked FLEX options similarly to non-FLEX options, noting that this consistency should prevent confusion.

The Exchange also proposes that an RFQ remain open that trading day, as opposed to expiring immediately, as long as a trade has not occurred. As with non-FLEX options, before attempting to trade on an existing BBO, the market should be re-quoted. The advantage of an RFQ remaining open is that a re-quote does not require the submission of a new RFQ, thereby avoiding the delay of a new response time where such time may not be needed due to a recent quote. Because an option quoted earlier in the trading day should be easier to price, such that a new response time is not required, the Exchange believes that it may be burdensome to repeat the RFQ process. Thus, RFQs remaining open streamlines FLEX trading and eliminates unnecessary delays. Any time a market is re-quoted that day, the new BBO and any resulting trade are disseminated with reference to the original RFQ. However, once a trade occurs, a new RFQ is required.[39]

Certain aspects of proposed Rule 1079 differ from FLEX provisions of other exchanges. For instance, discretionary transactions would not be permitted in index and equity FLEX options.[40] Thus, the existing provisions of Rule 1065 will apply to prohibit such transactions.

Second, the Exchange also notes that there may not be a Specialist in FLEX options. Where there is an assigned FLEX Specialist, that FLEX option will trade pursuant to the Phlx's specialist system. Where there is no assigned FLEX Specialist, two assigned ROTs are required. Only the assigned Specialist in the non-FLEX (listed) option may apply to be an assigned Specialist in the FLEX option,[41] but is not required to do so in order to participate. Instead, the non-FLEX Specialist may be an assigned ROT in the FLEX option, or not assigned at all. The current responsibilities of a Specialist to determine a market based on the bids and offers voiced as well as to disseminate bids/offers and trades may be handled by the Requesting Member, where there is no assigned Specialist in that FLEX option. If a trade occurs where the Requesting Member is not a participant and there is no assigned Specialist, the responsibility to submit the trade falls upon the seller or largest participant, in accordance with existing trading procedure.[42]

Third, the Exchange has also determined that FLEX options will trade in the crowd of the non-FLEX option in order to facilitate participation by assigned ROTs who will most likely be located in that crowd. The Exchange believes that encouraging market making activity, whether or not assigned, should foster liquidity in FLEX options.

Further, the proposed crossing procedure differs from that of other exchanges.[43] A guaranteed minimum right of participation of 25%, or a fair split, whichever is greater, applies to crosses in both index and equity FLEX options, other than broker-dealer crosses and solicited orders.[44] The purpose of the split is to attract interest in Exchange-traded FLEX options by guaranteeing members who bring FLEX orders to the Phlx as part of the contra-side participation on that trade when matching or improving the BBO.

[37] *See also, supra* note 5.

[38] The Exchange notes that although the principles of price/time priority and simultaneous bids/offers at parity of Rule 1014 apply, the enhanced specialist participation of sub-paragraphs (g) (ii) and (iii) are not applicable to FLEX options.

[39] The Exchange notes that the Options Committee may determine to establish an abbreviated response time for a new RFQ, because the full ten minutes may not be required for pricing determinations.

[40] *See e.g.,* CBOE Rule 24A.6.

[41] If the option is not listed on the Exchange, specialist functions may be allocated by the Exchange pursuant to Phlx Rules 500 et seq.

[42] *See* Floor Procedure Advice F–2, Time Stamping, Matching and Access to Matched Trades.

[43] Pursuant to CBOE Rule 24A.5(e)(iii), Submitting Members representing *index* FLEX crosses, after indicating an intention to cross or act as principal, have priority on the BBO for the largest of ½ of the trade, $1 million Underlying Equivalent Value (''UEV'') or the remaining UEV on a closing transaction, and if improving the BBO, for the largest of ⅔ of the trade, $1 million UEV or the remaining UEV on a closing transaction. With respect to *equity* FLEX option crosses, there is a right to a 25% split on both the CBOE and the Amex, and on the PSE if improving the BBO. *See e.g.,* Securities Exchange Act Release No. 37051 (March 29, 1996) (SR–CBOE–96–20).

[44] *See* CBOE Rule 24A.5(f).

Nevertheless, this procedure prevents other market participants who are obligated to provide markets, from being excluded from FLEX option crosses. This, in turn, should prevent assigned ROTs and assigned Specialists from being discouraged from assuming the obligations of FLEX options assignment. Thus, the Phlx believes that this crossing procedure should promote deep and liquid markets for FLEX options.

In determining the BBO after the response time ends, the time priority principles of Rule 1014 (as well as the size precedence provisions of Rules 119 and 120) do not apply. Instead, the best price is given priority, with all bids/offers at that price deemed to be parity, regardless of when during the response time such bid/offer was voiced. In addition, where two or more bids/offers are at parity, priority is afforded to bids/offers submitted by assigned ROTs or the assigned Specialist over non-assigned ROTs/Specialists. In addition, after the BBO Improvement Interval, an assigned ROT or assigned Specialist who responded with a market during the response time, even though that market did not constitute the BBO and even though such trader may not have responded during the Improvement Interval, may immediately join the new BBO. Lastly, when a market is requoted based on an open RFQ, an assigned ROT or assigned Specialist who responded to the open RFQ during the response time or BBO Improvement Interval may immediately join the re-quoted market, thus matching for parity purposes. These procedures are intended to attract market maker interest, and thus liquidity, to FLEX options trading. In summary, the purpose of these provisions is to encourage assignment and reward those who actively make markets.

In view of the obligations of assigned ROTs and Specialists to make a market of a certain minimum size as well as that each FLEX option traded must have at least two assigned ROTs or assigned Specialists, the Exchange believes this ability to match is critical to the success of the product. The Exchange notes that the priority that an assigned ROT or assigned Specialist has over non-assigned market participants in voicing bids/offers and determining the BBO is similar to that of other exchanges.[45] This priority is limited to voicing bids/offers to establish a BBO. For purposes of joining bids/offers during or after the BBO Improvement Interval, parity, not priority, is afforded to assigned ROTs and the assigned Specialist. Priority for assigned ROTs and the assigned Specialist is also based on the need to offset the obligations of assigned ROTs and the assigned Specialist.

The Exchange has also added language to the text of the proposed rule stating that all transactions must be in compliance with Section 11(a) of the Act and the rules promulgated thereunder, in order to emphasize that such provisions apply, and for consistency with provisions of other exchanges.[46] Pursuant to Section 11(a) of the Act, bids/offers relying on the exemption of Section 11(a)(1)(G) must yield time priority to any bid/offer of a customer. Thus, due to Section 11(a), assigned ROTs/Specialists would not be afforded priority pursuant to Rule 1079 over a customer. In addition, crossing transactions may not be subject to a minimum right of participation, because a customer-to-customer cross would not be required to yield the remainder (75%) to assigned ROTs/Specialists.

The purpose of adopting new Advice F–28 is to incorporate it into the Floor Procedure Advice Handbook for easy reference on the trading floor. The principal provisions of Rule 1079(b) establishing a FLEX options trading procedure are incorporated into the Advice, with a citation to the full text of Rule 1079 for additional provisions.

Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6 of this Act in general, and in particular, with Section 6(b)(5), in that it is designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, as well as to protect investors and the public interest, by creating a FLEX options trading procedure in proposed Rule 1079 to enable the trading of flexible index and equity options. The Exchange believes that the proposed trading procedure, crafted in consideration of the complexity of variable terms and the larger sizes reflective of institutional users, should ensure that just and equitable principles of trade govern FLEX options trading. The Exchange also believes that the financial requirements and assigned ROT and assigned Specialist obligations should promote liquidity, as well as the protection of investors trading FLEX options. Furthermore, the customization of option features and terms should enable investors to better manage trading and investment risk as well as more closely tailor Exchange-traded options to their specific investment strategies and objectives. Thus, FLEX options unite certain attributes of negotiated transactions with the many benefits of an exchange auction marketplace, including transparency and OCC as guarantor.

Because the proposed procedure is designed to minimize market impact and contains important customer protection provisions, the Exchange believes that it should prevent fraudulent and manipulative acts and practices. The Exchange also believes that the proposal is consistent with Section 11A, because FLEX options enable the Exchange to compete fairly with other exchanges and the OTC market, as well as with Section 11(a), because customer priority is preserved under the proposal.

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

The Phlx does not believe that the proposed rule change will impose any inappropriate 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 either solicited or received.

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

With 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 or such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Phlx 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, DC 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

[45] *See e.g.,* CBOE Rule 24A.5(e) (i) and (ii).

[46] *See e.g.,* CBOE Rule 24A.5(e).

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, DC 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 File No. SR–Phlx–96–38 and should be submitted by May 15, 1997.

For the Commission by the Division of Market Regulation, Pursuant to delegated authority.[47]

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–38527; International Series Release No. 1075; File No. SR–PHLX–97–07]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Regarding 3D Foreign Currency Option Holiday Expirations

April 18, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] notice is hereby given that on March 14, 1997, the Philadelphia Stock Exchange, Inc. ("PHLX" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "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 PHLX proposes not to list any 3D foreign currency options that would expire during the period December 20 through and including January 2 of each year. Additionally, the Exchange proposes to adopt a list of holidays and bank holidays which, if they fall on a Monday, would cause the 3D foreign currency options scheduled to expire that day to expire the next business day. The holidays are: Martin Luther King, Jr. Day; Memorial Day; Presidents Day; Independence Day; Easter Monday; Labor Day; May Day; Columbus Day and Veterans Day.

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 Exchange 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 Exchange 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

3D Foreign Currency Options ("3D FCOs") are presently traded on the PHLX on the German mark and the Japanese yen.[2] These are cash settled options that have an expiration every Monday at 11:59 p.m. Eastern Time (or the following business day if Monday is a holiday). The settlement value is based on a formula which averages random samples of bids and offers from contributor banks. Experience with the 3D FCO on the German mark over the last two years has shown that it is often difficult to gather enough updated quotes during the Christmas and New Year's weeks each year. Thus, the integrity of the derived settlement value may be called into question. Accordingly, the Exchange has determined not to list for trading any series of 3D FCOs which would expire between December 20 each year and January 2 of the following year. This year, the last expiration date of 3d FCOs in December would occur on December 15, 1997, and the next one would occur on January 5, 1998.

The second purpose of this rule change is to adopt a permanent list of holidays, so that if any of these holidays occur on a Monday, it would cause the expiration of the 3D FCOs to occur on the following business day pursuant to Exchange Rule 1000(b)(21)(iii).[3] By adopting a permanent schedule, it will allow the Exchange and investors to know for certain, in advance, when a holiday expiration will occur. The holidays on the list were chosen because they are either U.S. bank holidays or European bank holidays (May Day). On those days, the interbank foreign exchange participants which provide quotations for the settlement value are not open for business so it would be very difficult to obtain an adequate settlement value. This list of holidays will be published to the membership in a circular each year and weekly expiration memos also note when certain options expire on a day other than a Monday due to a holiday.

The proposed rule change is consistent with Section 6 of the Act in general, and in particular, with Section 6(b)(5), in that it is designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, 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, as well as to protect investors and the public interest by adopting policies regarding 3D foreign currency option expirations which allow the Exchange to forego or postpone expirations on days when the integrity of the settlement value may be in question.

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

The PHLX does not believe that the proposed rule change will impose any inappropriate 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 either solicited or received.

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 PHLX consents, the Commission will:

[47] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. § 78s(b)(1).

[2] The Exchange has traded 3D German marks since September of 1994. *See* Securities Exchange Act Release No. 33732 (March 8, 1994), 59 FR 12023 (March 15, 1994). The Exchange recently started trading 3D options on the Japanese yen on February 24, 1997. *See* Scurities Exchange Act Release No. 36505 (Nov. 22, 1995), International Series Release No. 889, 60 FR 61277 (Nov. 29, 1995).

[3] The rule originally required expirations to fall back to the preceding business day (usually Friday) when Monday was a holiday but was changed so that the options would still capture weekend risk. *See* Securities Exchange Act Release No. 35097 (Dec. 13, 1994), 59 FR 65559 (Dec. 20, 1994).