

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

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

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

February 4, 2000.

I. Introduction

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

The proposed rule change was published for comment in the **Federal Register** on April 2, 1999.⁴ No comments were received on the proposal. On November 10, 1999, the Phlx filed an amendment to the proposed rule change.⁵ This order approves the proposal, as amended.

II. Description

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

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

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

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Sections 6 of the Act.⁸ Specifically, the Commission believes that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

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

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

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

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

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

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

The Commission has carefully considered the Phlx's proposal. At the outset, the Commission notes that it still believes that the fundamental purposes of position and exercise limits are being served by their existence. Nevertheless, the Commission believes that the Phlx's current experience with the trading of market index options¹² make it

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

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

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

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

¹⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Position limits impose a ceiling on the number of option contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls) that can be held or written by an investor or group of investors acting in concert.

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

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

permissible to increase position and exercise limits for certain market index options while still ensuring that large positions in such index options will not unduly disrupt the options or underlying cash markets.

The Commission believes that an increase in position and exercise limits for certain market index options is appropriate for several reasons. The Commission notes first that the proposal is limited to options on three market indexes, the VLE, TPX and XOC. The Commission believes that the capitalization of, and relatively deep, liquid markets for, the underlying securities contained in these indexes significantly reduces concerns regarding market manipulation or disruption in the underlying market.¹³ Increasing position and exercise limits for these index options may also bring additional depth and liquidity, in terms of both volume and open interest, to the affected index options classes without significantly increasing concerns regarding intermarket manipulations or disruptions of the options or the underlying securities.

Second, increasing position and exercise limits for these specific indexes should better serve the hedging needs of institutions that engage in trading strategies different from those covered under the index hedge exemption policy (e.g. delta hedges, OTC vs. listed hedges).

Third, the Commission believes that financial requirements imposed by Phlx and by the Commission adequately address concerns that a Phlx member or its customer may try to maintain an inordinately large unhedged position in a market index option. Current margin and risk-based haircut methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large

22044 (May 17, 1985), 50 FR 21532 (May 24, 1985) (order approving SR-Phlx-84-28, establishing the XOC index option).

¹³ VLE is an equally weighted, arithmetically averaged index based on the approximately 1,700 listed and over-the-counter stocks followed and published by Value Line, Inc. in the Value Line Investment Survey. As of September 29, 1999, the total market capitalization for VLE was \$14.5 trillion. Telephone call between John Dayton, Phlx, and Christine Richardson, Commission, September 30, 1999. TPX is a capitalization-weighted index composed of the 100 most highly capitalized U.S. corporations, including both listed and Nasdaq National Market System traded securities. As of October 14, 1999, the total market capitalization for TPX was \$7.5 trillion. XOC is capitalization-weighted and composed of the common stocks of the 100 largest capitalized corporations whose stocks are traded over-the-counter. As of October 14, 1999, the total market capitalization for XOC was \$2.2 trillion. See Phlx website at <http://www.Phlx.com>.

position held by itself or by its customer.¹⁴ Phlx also has the authority under its rules to impose a higher margin requirement upon the member or member organization when it determines that market conditions so warrant. Monitoring accounts maintaining large positions should provide the Exchange with the information necessary to determine whether to impose additional margin and/or whether to assess capital charges upon a member organization carrying the account. In addition, the Commission's net capital rule, Rule 15c3-1 under the exchange Act, imposes a capital charge on members to the extent of any margin deficiency resulting from the higher margin requirement. The significant increases in unhedged options capital charges resulting from the September 1997 adoption of risk-based haircuts and Phlx's margin requirements applicable to these products under Exchange rules serves as an additional form of protection.¹⁵ The Commission also notes that the OCC will serve as the counter-party guarantor in every exchange-traded transaction.

Fourth, the Commission notes that the index options and other types of index-based derivatives (e.g., forwards and swaps) are not subject to position and exercise limits in the OTC market. The Commission believes that increasing position and exercise limits for the VLE, TPX, and XOC options will better allow Phlx to compete with the OTC market.

Fifth, the Commission believes that Phlx's surveillance procedures will adequately allow it to detect and deter potential trading abuses arising from the increased position and exercise limits for VLE, TPX and XOC options. The absence of any discernible manipulative problems for broad-based index options at existing levels leads the Commission to conclude that the proposed increases are reasonable and that they can be safely implemented. The Commission believes that the Phlx's surveillance program is adequate to detect and deter violations of position and exercise limits, as well as to detect and deter attempted manipulation and other trading abuses through the use of such

¹⁴ Exchange Act Rule 15c3-1 requires a capital charge equal to the maximum potential loss on a broker-dealer's aggregate index position over a + (-) 10% market move. Exchange margin rules require margin on naked index options, which are in or at-the-money equal to a 15% move in the underlying index; and a minimum 10% charge for naked out-of-the-money contracts. At an index value of 9,000 this approximates to a \$135,000 to \$90,000 requirement per each unhedged contract.

¹⁵ See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997) Adopting Risk-Based Haircuts); and Phlx Rule 722 Margins.

illegal positions by market participants.¹⁶ In addition, the Phlx has submitted to the Commission a detailed description of enhanced surveillance procedures the Exchange will implement in order to monitor accounts maintaining large positions. The Commission believes that Phlx's new surveillance procedures should enable the Exchange to assess and respond to market concerns at an early stage. Although it is inappropriate to discuss the details of Phlx's enhanced surveillance program, the Commission notes that these enhanced procedures were critical in its determination to approve the proposed rule change.¹⁷

Sixth, the Commission believes that the enhanced reporting requirements should allow Phlx to detect and deter trading abuses arising from the elimination of position and exercise limits for VLE, TPX, or XOC. These reports should also allow Phlx to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if deemed necessary. Specifically, Phlx will subject VLE, TPX, and XOC to a 60,000 contract reporting requirement. Each member or member organization that maintains a position on the same side of the market in excess of these contract thresholds for its own account or for the account of a customer must file a report that includes, but is not limited to, data related to the option position, whether such position is hedged and if so, a description of the hedge. If applicable, the report must contain information concerning collateral used to carry the position. Exchange Registered Option Traders would be exempt from this reporting requirement.¹⁸

Seventh, the Commission notes that it recently approved proposed rule changes from the Chicago Board Options Exchange ("CBOE") and the American Stock Exchange ("Amex"), which were even less restrictive than the Phlx's current proposal. Specifically, those proposed rule changes eliminated position and exercise limits on a pilot basis for certain market index options traded on

¹⁶ The Commission emphasizes that the Phlx must closely monitor compliance with position and exercise limits and impose appropriate sanctions for failures to comply with the Exchange's position and exercise limit rules.

¹⁷ Disclosure of specific surveillance procedures could provide market participants with information that could aid potential attempts at avoiding regulatory detection of inappropriate trading activity.

¹⁸ See Amendment No. 1.

the CBOE and Amex.¹⁹ Although Phlx's VLE, TPX and XOC options are not identical to CBOE's or Amex's, the Commission believes that, given its approval of these proposed rule changes, the Phlx's proposed increase in position and exercise limits to three times their current level is appropriate.

Finally, the Commission believes it appropriate for the Exchange to eliminate language contained in Phlx Rule 1001A and 1101A, concerning the Big Cap Index ("MKT") since MKT is no longer traded on the Exchange. The Commission also believes it is appropriate for the Exchange to delete all references to options on the Super Cap Index, as these options were delisted from the Exchange on September 29, 1999.²⁰

The Commission finds good cause to approve Amendment No. 1 to the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 1 provides for a reporting requirement for member firms that should aid the Exchange in monitoring accounts with large positions in VLE, TPX, and XOC. Amendment No. 1 also makes certain minor technical changes. Accordingly, the Commission finds that, consistent with Sections 6(b) and 19(b)(2) of the Act, there is good cause to approve Amendment No. 1 to the proposed rule changes on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1, including whether the amendments are consistent with the Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written

¹⁹ See Exchange Act Release Nos. 41011 (February 1, 1999), 64 FR 6405 (February 9, 1999) (order approving File No. SR-Amex-98-38, eliminating position and exercise limits on a two year pilot basis for Institutional Index Options and Major Market Index Options and FLEX options on those index options); 40969 (January 22, 1999), 64 FR 4911 (February 2, 1999) (order approving File No. SR-CBOE-98-23, eliminating position and exercise limits on two year pilot basis for the S&P 500 Index, the S&P 100 Index, and the Dow Jones Industrial Average Index, and FLEX options on those indexes).

²⁰ See Amendment No. 1. This includes references in Phlx Rules 1079(d)(1), 1000A(b)(11), (c); 1047A(a)(i), (d), (f)(iv); and 1101A Commentary .01.

communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, located at the above address. Copies of such filing will also be available for inspection and copying at the principal office of the self-regulatory organization. All submissions should refer to File No. SR-Phlx-98-55 and should be submitted by March 2, 2000.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²¹ that the proposed rule change (SR-Phlx-98-55) be approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²²

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42388; International Series Release No. 1213; File No. SR-Phlx-99-30]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Respecting Non-Customized Cross-Rate Foreign Currency Option Margin Levels

February 4, 2000.

I. Introduction

On August 5, 1999, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend its method of calculating initial and maintenance customer margin requirements for non-customized cross-rate foreign currency options ("Cross-Rate FCOs"). The Exchange amended the proposal on October 26, 1999.³

²¹ 15 U.S.C. 78s(b)(2).

²² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 8s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, the Exchange requested that the Commission approve the existing 4% add-

The Commission published notice of the proposed rule change in the **Federal Register** on November 12, 1999.⁴ The Exchange filed a second amendment to the proposal on January 19, 2000.⁵ The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposal

The Exchange proposes to determine the add-on margin levels for all non-customized Cross-Rate FCOs using the methodology outlined in Commentary .16 to Phlx Rule 722, in lieu of the fixed four percent rate that the Exchange currently uses.

In 1991, the Commission approved the Exchange's proposal to list and trade three non-customized Cross-Rate FCOs—German mark/Japanese yen, British pound/German mark and British pound/Japanese yen options.⁶ The Commission's 1991 order approved a four percent add-on margin level for the non-customized Cross-Rate FCOs for a one-year period only, because these products were new products and the Commission was concerned that the volatility in the underlying currencies could change significantly. Accordingly, the Commission stated that the Exchange should further analyze the add-on margin adequacy, and, within nine months, submit the analysis along with a proposed rule change to retain the margin level or establish a new level.

Based on the 1991 Order, the Exchange's customer margin

on margin for all non-customized cross-rate foreign currency options until February 4, 2000, prior to the thirtieth day after the publication of the notice thereof in the **Federal Register**; provided statistical data to substantiate the proposed rule change; and made substantive changes to the proposed rule text. See Letter from Nandita Yagnik, Counsel, Phlx, to Hong-anh Tran, Attorney, Division of Market Regulation ("Division"), Commission, dated October 25, 1999 ("amendment No. 1").

⁴ Securities Exchange Act Release No. 42093 (November 3, 1999), 64 FR 61682 (November 12, 1999) (File No. SR-Phlx-99-30).

⁵ In Amendment No. 2, the Exchange made technical changes to the proposed rule text. Specifically, the Exchange proposes to modify the introductory portion of Commentary .16 to Phlx Rule 722 to clarify that the Commentary .16 methodology applies to non-customized Cross-Rate FCOs, but not to customized Cross-Rate FCOs. The Exchange also proposes replacing the word "currency" with the term "currency pair" throughout Paragraph (c) of Commentary .16, and adding the word "the" before the word "base currency" in Paragraph (a) of the same commentary. See Letter from Nadita Yagnik, Counsel, Phlx, to Hong-anh Tran, Attorney, Division of Market Regulation ("Division"), Commission, dated January 18, 2000 ("Amendment No. 2").

⁶ See Securities Exchange Act Release No. 29919 (November 7, 1991), 56 FR 58109 (November 15, 1991) ("1991 Order"). Although the Exchange received approval for the British pound/Japanese yen Cross-rate FCO, the Exchange has not listed such a contract.