

[Release No. 34-37810; File No. SR-PSE-96-09]

Self-Regulatory Organizations; Pacific Stock Exchange, Inc.; Order Approving Proposed Rule Change by the Pacific Stock Exchange Incorporated and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to Proposed Rule Change Relating to the Options Book Pilot Program

October 11, 1996.

I. Introduction

On April 1, 1996, the Pacific Stock Exchange, Inc. ("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")¹ and Rule 19b-4 thereunder,² a proposal to establish a pilot program under which a limited number of lead market makers ("LMMs") will be able to assume operational responsibility for the options public limit order book ("Book") in certain options issues.³ The Exchange filed an amendment ("Amendment No. 1")⁴ to the proposed rule change on June 4, 1996. The proposed rule change was published for comment in the Federal Register on June 27, 1996.⁵ The Exchange filed a second amendment ("Amendment No. 2") to the proposed rule change on October 3, 1996.⁶ No comments were received on the proposed rule change. This order approves the Exchange's proposal.

II. Description of the Proposal

The Exchange proposes to amend its rules governing LMMs to allow

approved LMMs to manage the Book function in certain designated options issues. The Exchange believes that the proposed rule change will give the Exchange greater flexibility in the operation of its lead market maker program ("LMM Program"). It will allow approved LMMs to have greater control over their operations on the Exchange floor. In particular, it will allow them to set rates for execution services provided to customers, in a manner similar to that exercised by options specialists at other exchanges and Designated Primary Market Makers at the Chicago Board Options Exchange. Accordingly, the Exchange believes that the rule change will make the PSE's LMM Program more competitive.⁷

The Book pilot program will be implemented on a limited basis, involving no more than three LMMs and no more than forty options symbols in total,⁸ during a one-year pilot phase. No market maker cooperatives will be permitted to participate in the pilot.⁹ The Exchange will evaluate the program, and, six months prior to its expiration, will determine whether to modify it and whether to seek permanent approval from the Commission. Under the pilot, the designated LMMs will manage the Book function, take responsibility for trading disputes and errors, set rates for Book execution, and pay the Exchange a fee for systems and services.

The LMMs who participate during the pilot phase will be selected by the Options Floor Trading Committee based on some or all of the following factors: experience with trading an options issue as a market maker or LMM and willingness to assume LMM responsibilities; trading volume of the options issue(s); adequacy of capital; willingness to promote the Exchange as a marketplace; history of adherence to Exchange rules and securities laws; trading crowd/LMM evaluations conducted pursuant to Options Floor Procedure Advice B-13; and ability to manage the Book operation. Only dually- or multiple-traded options issues will be eligible during the pilot phase.

The Exchange proposes to amend its Rule 6.82 to provide that, subject to the approval of the Exchange, LMMs will be

eligible to perform all functions of the Order Book Official ("OBO") in designated options issues pursuant to Rules 6.51 through 6.59. In that regard, the Exchange will allow the LMM to use Exchange personnel to assist the LMM in performing the OBO function, and the Exchange will charge the LMM a reasonable fee for such use of Exchange personnel. If the program is made permanent, it is contemplated that LMMs would be responsible for hiring and maintaining their own employees, but the Exchange would provide employees to assist LMMs when necessary due to market conditions. Whether employed by LMMs or by the Exchange, however, employees working in the Book operation will be subject to all rules, policies, and procedures established by the Exchange. In addition, LMMs will be required to resolve trading disputes, subject to the review of two floor officials, upon the request of any party to such dispute. LMMs also will be required to disclose Book information to members upon request, pursuant to PSE Rule 6.57.

With regard to their duties as market makers, LMMs will be required to perform all obligations provided in Rules 6.35 through 6.40 and 6.82(c). In addition, in executing transactions for their own "market maker" accounts, LMMs will have a right to participate pro rata with the trading crowd in trades that take place at the LMM's principal bid or offer.

The proposal further provides that if the Options Allocation Committee decides to reallocate an options issue to the market maker system pursuant to PSE Rule 6.82(f)(i),¹⁰ the terminated LMM may receive a proportionate share of the net Book revenues, not to exceed one-half, for any period specified by the Options Appointment Committee up to a maximum of five years. The decision to make an award will be based on various factors, including: the length of the time of LMM service, the LMM's capital commitment; efforts expended as LMM; activity level of the options issue when the LMM assumed responsibility for the Book function; and other relevant factors. The Exchange intends to develop a procedure for determining "net Book revenues" and specific guidelines for the Options Appointment Committee to follow in determining the

¹ 15 U.S.C. 78s(b)(1) (1988).

² 17 CFR 240.19b-4.

³ An "options issue" refers to all types of options contracts (puts and calls) of the same class of options covering the same underlying stock. See PSE Rule 6.1(a) (7) and (10).

⁴ Amendment No. 1 adds a provision to proposed PSE Rule 6.82, Commentary .05 stating that no market maker cooperatives may participate as LMMs in the pilot program. Amendment No. 1 also replaces a PSE Rule 6.82, Commentary .05 reference to "April —, 1997" as the proposed expiration date for the pilot program, with a reference to "[Date]". Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Michael Walinskas, Special Counsel, Office of Market Supervision ("OMS"), Division of Market Regulation ("Division"), Commission, dated June 4, 1996.

⁵ See Securities Exchange Act Release No. 37335 (June 19, 1996), 61 FR 33568.

⁶ Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Janet Russell-Hunter, Special Counsel, Office of Market Supervision ("OMB"), Division of Market Regulation ("Division"), Commission, dated October 3, 1996. Amendment No. 2 clarifies the purpose of the proposal, amends proposed Rule 6.82(h) to change a reference to another part of the rule, and requests accelerated approval of Amendment No. 2.

⁷ Amendment No. 2, *supra* note 6.

⁸ Amendment No. 1, *supra* note 4.

Each options issue typically has only one symbol associated with it, unless LEAPs are traded on that issue, in which case there usually would be two additional symbols related to the issue, or unless a contract adjustment is necessary due, for example, to a merger or stock split, in which case one additional symbol usually would be added.

⁹ Amendment No. 1, *supra* note 4.

¹⁰ In Amendment No. 2, the Exchange is making a technical correction to the proposal by changing the cross reference in proposed Rule 6.82(h)(1)(e) from (f)(2) to (f)(1). This change is being made to reflect a change in another filing, and accordingly, this change to the filing is not substantive. See Amendment No. 2, *supra* note 6. See also Securities Exchange Act Release No. 37780, (October 3, 1996) (approving changes to the LMM Program).

amount of net Book revenues, if any, to be awarded.

The proposal specifies that LMMs who perform the function of an OBO pursuant to PSE Rule 6.82(h) shall maintain "minimum net capital," as provided in Rule 15c3-1 under the Act,¹¹ and also shall maintain a cash or liquid asset position of at least \$500,000, plus \$25,000 for each options issue over five issues for which they perform the function of an OBO.

The Exchange believes that the proposal is consistent with Section 6(b) of the Act, in general, and Section 6(b)(5), in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, and to protect investors and the public interest.

III. Discussion

PSE Rule 6.82 ("LMM Rule") sets forth the basic rules and procedures applicable to the LMM Program. The Commission notes that the LMM Program was adopted in January 1990 as a pilot program.¹² The Commission recently approved changes to the LMM Program that added several new substantive provisions to the LMM Rule and clarified and streamlined its existing provisions.¹³ In addition, the pilot LMM Program recently was extended to September 30, 1997.¹⁴ The Exchange is now proposing to establish a pilot program whereby LMMs will assume operational responsibility for the Book in a limited number of options issues.

After careful consideration, the Commission finds that the Exchange's proposal to create a limited pilot program is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange in that the proposal is consistent with Section 6(b) of the Act, in general, and Section 6(b)(5), in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, and to protect investors and the public interest. Giving LMMs greater control over their operations on the Exchange floor may continue to enhance the PSE's LMM Program, thereby improving the market for listed options on the Exchange. The Book pilot program is approved for a one year period, to expire on October

31, 1997, unless extended or permanently approved.

The Commission finds in particular that the program will be implemented on a limited basis involving no more than three LMMs and no more than forty options symbols in total during a one-year pilot phase. The Commission finds the selection criteria for LMMs to participate in this limited pilot to be appropriate. The Commission finds consistent with the Act the requirement that any LMMs who perform the function of an OBO will be required to maintain minimum net capital pursuant to Rule 15c3-1 under the Act, as well as a cash or liquid asset position of at least \$500,000, plus \$25,000 for each options issue over five issues for which they perform the function of an OBO.¹⁵ The Commission finds appropriate that no market maker cooperatives will be permitted to participate in the pilot.¹⁶

The Commission believes that the pilot contains adequate safeguards to permit proper Exchange oversight of the LMMs managing the Book function. Specifically, the Commission finds appropriate that LMMs will be designated as OBOs and perform OBO functions pursuant to Rules 6.51 through 6.59.¹⁷ These functions include the OBO's duty to assist in the maintenance of a fair, orderly, and competitive market.¹⁸ LMMs running the Book will be required to report to an Options Floor Official any unusual trading activity, transactions, or price changes, or other unusual market conditions or circumstances that are detrimental to the maintenance of a fair, orderly, competitive market.¹⁹ LMMs also will be required to disclose to members, upon request, the price and number of contracts which are bid below or that are offered above the Book information displayed pursuant to Rule 6.55.²⁰ The Commission also notes that the proposal incorporates the requirement that LMMs perform all market maker obligations provided in Rules 6.35 through 6.40 and 6.82(c).²¹

The Commission finds consistent with the Act that the proposal places additional obligations on LMMs, and provides for their support by the Exchange. The proposal includes a provision subjecting an LMM's resolution of a trading dispute to the review of two floor officials upon the request of any party to such dispute.²²

The proposal also requires the PSE, for a reasonable fee, to make available Exchange personnel to assist LMMs in their OBO functions, though if the pilot is permanently approved, LMMs may be responsible for hiring and maintaining their own employees. The Commission notes that employees working in the Book operation, whether employed by an LMM or the Exchange, will be subject to all rules, policies, and procedures established by the Exchange. Finally, the Commission finds that the LMM Rule contains adequate provisions to permit the Exchange to reassign one or more options issues in the event that an LMM has not performed its duties satisfactorily.²³

The Commission finds appropriate the provision of the proposal permitting an LMM to receive a proportionate share of net Book revenues for a limited time, in the event that an options issue is reallocated to the market maker system.²⁴ The Commission finds that it is appropriate for the Exchange to have the discretion to determine what compensation, if any, an LMM should receive in the event of reallocation of an options issue.

The Commission notes that, pursuant to recent amendments to the LMM Rule, LMMs will be evaluated by the Options Allocation Committee at least semiannually.²⁵ Before the Book pilot program can be approved on a permanent basis, or further extended, however, the Exchange must provide the Commission, within 6 months prior to its expiration, with a report on the operation of the Book pilot program. Specifically, the PSE must submit an updated pilot program report by April 1997 that addresses: (1) Whether there have been any complaints regarding the operation of the pilot; (2) whether the PSE has taken any disciplinary or performance action against any member due to the operation of the pilot; (3) whether the PSE has reassigned any options issues traded pursuant to the pilot; and (4) the impact of the pilot on the bid/ask spreads, depth and continuity in PSE options markets.

The Committee finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of the publication of notice of filing thereof in the Federal Register because Amendment No. 2 does not change the substance of the proposal, rather, it clarifies the purpose for the proposal and makes a technical correction to the text of the proposed rule. In addition,

¹¹ 17 CFR 240.15c3-1.

¹² See Securities Exchange Act Release No. 27631 (January 17, 1990), 55 FR 2462.

¹³ Securities Exchange Act Release No. 37780, *supra* note 10.

¹⁴ See Securities Exchange Act Release No. 37767 (September 30, 1996).

¹⁵ Proposed PSE Rule 6.82, Commentary .06.

¹⁶ Amendment No. 1. *supra* note 4.

¹⁷ See Proposed PSE Rule 6.82(h)(1)(a).

¹⁸ See PSE Rule 6.53.

¹⁹ See PSE Rule 6.54.

²⁰ See PSE Rule 6.57.

²¹ Proposed PSE Rule 6.82(h)(2)(a).

²² Proposed PSE Rule 6.82(h)(1)(c).

²³ See PSE Rule 6.82(f).

²⁴ Proposed PSE Rule 6.82(h)(1)(e).

²⁵ See PSE Rule 6.82(e)(4) and Securities Exchange Act Release No. 37780, *supra* note 10.

the PSE's proposal was published in the Federal Register for the full 21 day comment period without any comments being received by the Commission.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2. 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 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, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the PSE. All submissions should refer to File No. SR-PSE-96-09 and should be submitted by November 8, 1996.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁶ that the proposed rule change (File No. SR-PSE-96-09), as amended, is approved through October 31, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority:²⁷

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-37813; File No. SR-PTC-96-05]

Self-Regulatory Organizations; Participants Trust Company; Order Granting Accelerated Approval of a Proposed Rule Change Relating to Establishing a New Category of PTC Participant

October 11, 1996.

On August 21, 1996, the Participants Trust Company ("PTC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-PTC-96-05) pursuant to

Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")¹ to establish a new category of PTC participant, a "Federal Reserve participant." Notice of the proposal was published in the Federal Register on September 23, 1996.² No comment letters were received. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

I. Description

The proposed rule change establishes a new category of PTC participant, a Federal Reserve participant, for Federal Reserve Banks.³ The new category of participants will enable Federal Reserve Banks to maintain accounts at PTC for the purpose of accepting securities pledged as collateral by PTC participants for discount window advances from the Federal Reserve Banks. At a later date, PTC participants may be able to deliver securities to the accounts of Federal Reserve participants as collateral to secure Treasury tax and loan accounts.⁴

Following approval of this proposed rule change, PTC and the Federal Reserve Bank of New York ("FRBNY") will commence a pilot program which will be open to a limited number of PTC participants. During the pilot program, PTC participants taking part in the pilot program will be able to deliver securities that meet the requirements of the FRBNY to the FRBNY's Federal Reserve participant's account to secure discount window advances. During the pilot program, PTC also will undertake software changes that may later permit pledges of Treasury tax and loan collateral and pledges of collateral by institutions that are not direct participants themselves but use PTC participants as custodians.⁵

¹ 15 U.S.C. 78s(b)(1) (1988).

² Securities Exchange Act Release No. 37684 (September 16, 1996), 61 FR 49807.

³ The new category of Federal Reserve participant will be governed by a new Section 2A to Rule 1 of Article IV of PTC's rules ("Qualifications and Duties of Participants and Limited Purpose Participants") and by a new form of participation agreement for Federal Reserve participants.

⁴ A financial institution can be designated as a Treasury tax and loan depository to process deposits of Federal taxes and to maintain and administer separate accounts known as Treasury tax and loan accounts. In order to accept these deposits, the financial institution must pledge collateral security to secure Treasury tax and loan balances with the Federal Reserve Bank of the district in which it is located. 31 CFR 202, 203.

⁵ Many smaller institutions which cannot meet PTC's participants' requirements establish clearing arrangements with PTC participants in order to utilize PTC's services.

As necessary, PTC should submit a proposed rule change under Section 19(b) of the Exchange Act describing any modifications to the program which

Establishing the Federal Reserve participant as a category of participation will enable Federal Reserve Banks to participate in PTC in a capacity different from that of PTC's current participants or limited purpose participants.⁶ Like limited purpose participants, Federal Reserve participants will be restricted from receiving securities versus payment and from incurring a debit balance. In addition, Federal Reserve participants will not receive principal and interest ("P&I") advances on securities held at PTC and therefore are not required to repay third-party loans obtained for this purpose.⁷

Consistent with the restricted nature of Federal Reserve Bank participation, the proposed rule change also provides that Federal Reserve participants will be exempt from some of the obligations applicable to PTC's other participants and limited purpose participants.⁸ The most significant exemptions applicable to Federal Reserve participants are that they are not required to: (1) Indemnify PTC or any licensor or provider of data processing services to PTC; (2) furnish periodic financial reports and open books and records for inspection by PTC; (3) pay fees, fines, or assessments; (4) contribute to the participants fund; or (5) submit disputes to arbitration.

Additional provisions of the proposed rule change are as follows. Securities and property in the account of a Federal Reserve participant are not subject to any lien, security interest, or ownership interest by PTC.⁹ PTC shall not be liable to a Federal Reserve participant or any third party for losses arising from nonperformance or misperformance of the custody of deposited securities or its duties other than the custody of deposited securities except to the extent that such loss is attributable to the failure to exercise ordinary care by PTC or in the case of willful misconduct or fraudulent or criminal acts of PTC. PTC will not waive any of its rules or procedures without a Federal Reserve participant's consent if the effect of such

PTC plans to implement as a result of its review of the pilot program.

⁶ Currently, PTC's rules permit participation as either a participant or as a limited purpose participant.

⁷ Federal Reserve participants will not receive P&I through PTC because P&I on securities in a pledgee account is paid to the pledgor pursuant to PTC's rules.

⁸ These exemptions are set forth in the new Section 2A to Rule 1 of Article IV of PTC's rules.

⁹ Because securities held by PTC for the account of a Federal Reserve participant are held in pledgee accounts and transferred free into such accounts, this change is merely a restatement of PTC's existing rules, which provide that PTC does not have a lien, security interest, or ownership interest in securities held and transferred in this manner.

²⁶ 15 U.S.C. 78s(b)(2) (1988).

²⁷ 17 CFR 200.3-3(a)(12).