

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40814; File No. SR-NASD-98-78]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Equity Option Hedge Exemption

December 21, 1998.

I. Introduction

On October 15, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary NASD Regulation ("NASD Regulation"), filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"),¹ and Rule 19b-4 thereunder.² In its proposal, NASD Regulation seeks to make permanent the Equity Option Hedge Exemption, which has been operating as a pilot program since 1990. Notice of the proposal was published in the **Federal Register** on November 16, 1998 ("Notice").³ No comments were received. This order approves the proposal.

II. Description of the Proposal

The purpose of the proposed rule change is to make permanent the NASD's Equity Option Hedge Exemption program ("Hedge Exemption"), which has been operating on a pilot basis since 1990. NASD Rule 2860(b)(3) provides that the position limits for equity options are determined according to a five-tiered system in which more actively traded stocks with larger public floats are subject to higher position limits. Under the NASD rules, the current basic position limits are as follows. For standardized equity options,⁴ the current basic position

limits are: 4,500, 7,500, 10,500, 20,000 and 25,000 contracts. For conventional equity options,⁵ the current basic position limits are three times the standardized equity options position limits, *i.e.*, 13,500, 22,500, 31,500, 60,000 and 75,000 contracts. NASD rules do not specifically govern how a particular equity option falls within one of the five position limit tiers. Rather, the NASD's position limit rule provides that the position limit established by an options exchange for a particular equity option is the applicable position limit for purposes of the NASD's rule.⁶

The Hedge Exemption provides for an automatic, limited exemption from position limits⁷ and exercise limits⁸ for equity options that are hedged using one of the four most commonly used hedge positions: (1) Long stock and short call; (2) long stock and long put; (3) short stock and long call; and (4) short stock and short put. The NASD rules also specify how an options contract must be hedged. To be properly hedged, the options contract must be: (i) hedged by 100 shares of stock, (ii) hedged by securities that are readily convertible into, or economically equivalent to, such stock,⁹ or (iii) in the case of an

respect to strike prices, expiration dates and the amount of the underlying security.

⁵ A conventional option is any option contract not issued, or subject to issuance by, the OCC.

⁶ For equity options that do not trade on an options exchange, the NASD's position limit rule provides that the limit for conventional equity options shall be three times the basic limit of 4,500 contracts, such as 13,500 contracts, unless the member can demonstrate to the Association that the underlying security meets the standards for higher limits and the initial listing standards for standardized options trading.

⁷ Position limits impose a ceiling on the number of options contracts of each options class on the same side of the market that can be held or written by an investor or group of investors acting in concert.

⁸ Exercise limits restrict the number of options contracts that an investor or group of investors acting in concert can exercise within five consecutive business days. Under NASD Rules, exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set forth as the applicable position limits for those options classes.

⁹ The Commission notes that the NASD determines on a case-by-case basis whether an instrument that is being used as the basis for an underlying hedged position is readily and immediately convertible into the security underlying the corresponding option position. In this regard, the NASD generally finds that an instrument which will become convertible into a security at a future date, but which is not presently convertible, is not a "convertible" security for purpose of the equity option position limit hedge exemption until the date it becomes convertible. In addition, if the convertible security used to hedge an options position is called for redemption by the issuer, the security would have to be converted into the underlying security immediately or the corresponding options position reduced accordingly.

adjusted options contract, hedged by the number of shares represented by the adjusted contract. Under the Hedge Exemption, the maximum standardized equity option position (combining hedged and unhedged positions) is three times the basic position limit level for standardized options, *i.e.*, 13,500, 22,500, 31,500, 60,000 or 75,000 contracts. Additionally, the maximum conventional equity option position (combining hedged and unhedged positions) is three times the basic position level for conventional equity options, *i.e.*, 40,500, 67,500, 94,500, 180,000 or 225,000 contracts.

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 association, and, in particular, the requirements of Section 15A.¹⁰ Specifically, the Commission believes that the NASD's equity options position limit hedge exemption will accommodate the needs of investors and market participants while at the same time furthering investor protection and the public interest.¹¹

The Commission believes that the Hedge Exemption is an important component of the options position limit rules and should be continued on a permanent basis. The Hedge Exemption is a necessary tool for market participants to manage their market exposure by allowing them the flexibility to hold larger options positions in cases where such positions are hedged. The Commission further believes that the Hedge Exemption provides depth and liquidity to the market and will allow investors to hedge their stock portfolios more effectively, without significantly increasing concerns regarding intermarket manipulations or disruptions of either the options market or the underlying stock market.

The Commission notes that the Hedge Exemption has been operating on a pilot basis since 1990. NASD Regulation has had eight years of experience administering and monitoring the program. The Commission believes that NASD Regulation has adequate rules in place to surveil the proposed hedge exemption. Specifically, NASD rules require each member to report options positions of any account which has established an aggregate position of 200

¹⁰ 15 U.S.C. 78o-3(b)(6).

¹¹ In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 40652 (Nov. 9, 1998), 63 FR 63764 (Nov. 16, 1998) (File No. SR-NASD-98-78).

⁴ Standardized equity options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that have standard terms with

or more option contracts of the put class and the call class on the same side of the market covering the same underlying security.¹² Finally, the Commission believes that approval of the NASD's Hedge Exemption on a permanent basis is appropriate in order to achieve parity with the exchange-trade options markets.¹³

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (SR-NASD-98-78) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40816; File No. SR-NASD-98-81]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change Relating to Application of the Corporate Financing Rule to Certain Offerings by Charitable Organizations

December 21, 1998.

I. Introduction

On October 29, 1998, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly-owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), submitted to 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 proposed rule change to amend NASD Rule 2710 ("Corporate Financing Rule") to exempt certain offerings by charitable organizations from the pre-offering filing requirements. The Commission published the proposed rule change for comment in the **Federal Register** on November 19, 1998.³ No comments

were received. This order approves the proposal.

II. Description of the Proposal

Rule 2710 currently subjects "church bond" offerings to a filing requirement with the Corporate Financing Department of NASD Regulation ("Department") so that the Department has an opportunity to determine whether compensation terms and arrangements are fair and reasonable for purposes of the rule. According to NASD Regulation, the aggregate underwriting compensation received by church bond broker/dealers has been significantly below the maximum amount of underwriting compensation that is permitted under Rule 2710.

Under the proposal, offerings of securities by a church or other charitable institution that are exempt from SEC registration pursuant to Section 3(a)(4) of the Securities Act of 1933 ("Securities Act")⁴ would be exempt from the filing requirements, but not the substantive requirements, of the Corporate Financing Rule. NASD Regulation proposes to implement the proposed rule change on the date of SEC approval.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 15A(b) of the Act and the rules and regulations thereunder applicable to a national securities association in general and, in particular, the requirements of Section 15A(b)(6) of the Act.⁵ Section 15A(b)(6) requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.⁶

The Commission believes that it is reasonable to eliminate the filing requirement in Rule 2710 for certain church bond offerings to allow NASD Regulation to better allocate its staff resources. The Commission notes that NASD Regulation has not recently identified any problems with these offerings and that the proposed exemption relates only to the filing

requirements, but not the substantive requirements, of Rule 2710. The Commission also notes that only the offerings that are exempt under Section 3(a)(4) of the Securities Act would be covered under the proposed exemption.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁷ that the proposed rule change (SR-NASD-98-81) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40813; File No. SR-OCC-98-06]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Market Coordination in the Application of Circuit Breakers

December 21, 1998.

On June 9, 1998, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") and on July 23, 1998 and October 27, 1998, amended the proposed rule change (File No. SR-OCC-98-06) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ Notice of the proposal was published in the **Federal Register** on November 5, 1998.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

I. Description

On April 9, 1998, the Commission approved amendments to the "circuit breaker" provisions of Rule 80B of the New York Stock Exchange ("NYSE").³ Under the amended Rule 80B, the securities markets could reopen after a trading halt and continue to trade in the range of 20 to 30 percent down while the rules of the Chicago Mercantile Exchange would not permit index

¹² See Rule 2860(b)(5).

¹³ See, e.g., American Stock Exchange Rule 904; Chicago Board Options Exchange Rule 4.11.

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 40676 (November 12, 1998), 63 FR 64303.

⁴ 15 U.S.C. 77c(a)(4). The Commission emphasizes that in order for the proposed exemption to apply the offering must qualify under Section 3(a)(4) of the Securities Act, which requires that the offering not be for pecuniary profit, and no part of the net earnings can inure to the benefit of any person, private stockholder, or individual.

⁵ 15 U.S.C. 78o-3(b)(6).

⁶ In approving this proposed rule change, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁷ 15 U.S.C. 78s(b)(2).

⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s (b) (1).

² Securities Exchange Act Release No. 40624 (October 30, 1998) 63 FR 59834.

³ Securities Exchange Act Release No. 39846 (April 9, 1998) 63 FR 18477. OCC submitted a comment letter in response to the notice of the proposed rule change. Letter from Wayne P. Luthringshausen, Chairman, OCC (March 23, 1998).