new test, an issuer with tangible net worth of at least $250 million would be able to issue ELDS without being subject to the limit that the ELDS be no more than 25 percent of the issuer's net worth. Issuers with tangible net worth of at least $150 million, but less than $250 million, will still be subject to the 25 percent limit.[6] This will provide the largest issuers with increased flexibility in their financing and capitalization planning.

With respect to the listing of ELDS linked to non-U.S. securities, the NYSE also proposes to amend the definition of ''Relative U.S. Share Volume'' and to delete the definition of ''Relative ADR Volume.'' Specifically, the NYSE proposes collapsing these two definitions into a single definition of ''Relative U.S. Volume.'' The Exchange states that this change is non-substantive and is proposed solely to clarify and simplify the rule.

III. Commission Finding and Conclusions

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, the requirements of Section 6(b)(5) of the Act.[7] Specifically, the Commission finds that the Exchange's proposal strike a reasonable balance between the Commission's mandates under Section 6(b)(5) to remove impediments to and perfect the mechanism of a free and open market and a national market system, while protecting investors and the public interest. In particular, the Commission believes that the trading of ELDS permits investors to more closely approximate their desired investment objectives through, for example, shifting some of the opportunity for upside gain in return for additional income.

ELDS, unlike standardized options, however, do not have a clearinghouse guarantee but are instead dependent upon the individual credit of the issuer. This heightens the possibility that a holder of an ELDS may not be able to receive full cash settlement at maturity. The Commission believes that the Exchange's proposed alternate ELDS issuer listing standard requiring issuers to have at least $250 million tangible net worth (without the issuance being limited to 25% of the issuer's net worth), in addition to the existing size and earnings requirements,[8] reasonably addresses this additional credit risk, and to some extent minimize this risk. The Commission also notes that the revised standard is identical to that approved for other issuer-based products, including index, currency, and currency index warrants.[9]

The Commission also believes that the NYSE's proposal to amend the definition of ''Relative U.S. Share Volume,'' delete the definition of ''Relative ADR Volume,'' and collapse the two definitions into a single definition of ''Relative U.S. Volume'' reasonably addresses its desire to clarify and strengthen its rule language.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[10] that the proposed rule change (File No. SR–NYSE–96–25) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[11]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–26064 Filed 10–9–96; 8:45 am]

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[6] The Commission notes that under the ELDS standards, issuers must have a minimum net worth of at least $150 million.

[7] 15 U.S.C. 78f(b)(5).

[8] *See* NYSE *Listed Company Manual* Paras. 102.01–102.03 or 103.01–103.05.

[9] *See* Securities Exchange Act Release No. 36165 (August 29, 1995), 61 FR 46653 (September 7, 1996) (SR–NYSE–94–41).

[10] 15 U.S.C. 78s(b)(2).

[11] 17 CFR 200.30-3(a)(12).

[Release No. 34–37780; File No. SR–PSE–96–03]

Self-Regulatory Organizations; Pacific Stock Exchange, Inc.; Order Approving and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1 and 2 to Proposed Rule Change Relating to the Lead Market Maker Program

October 3, 1996.

I. Introduction

On January 16, 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 relating to changes to its Lead Market Maker (''LMM'') Program. The proposed rule change was published for comment in the Federal Register on March 18, 1996.[3] The Exchange filed an amendment (''Amendment No. 1'')[4] to its proposal on August 11, 1996. The Exchange filed a second amendment (''Amendment No. 2'')[5] to its proposal on September 26, 1996. No comments were received on the proposed rule change. This order approves the Exchange's proposal as amended.

II. Description of the Proposal

PSE Rule 6.82 (''LMM Rule'') sets forth the basic rules and procedures applicable to LMMs and the LMM Program.[6] The Exchange proposes to modify Rule 6.82 by adding several new substantive provisions and by restructuring the rule and clarifying some of its existing provisions. The purpose of the proposal is to enhance the LMM Program and to clarify and streamline the LMM Rule. The proposed changes include, more specifically, the following:

1. Current PSE Rule 6.82(c)(6) provides that LMMs are guaranteed 50% participation in transactions occurring at their disseminated bids and offers in their allocated issues. The Exchange is proposing to create an exception to this provision.[7] Specifically, with regard to multiply-traded issues, the proposed rule will provide that if the average daily trading volume in an issue reached 3,000 contracts at the Exchange for three consecutive months, and if (i) in the case of an issue traded by two options exchanges, the Exchange's share of the total multi-exchange customer trading volume in the issue drops from above 70% to below 70%, or (ii) in the

[1] 15 U.S.C. 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 36952 (March 11, 1996), 61 FR 11072.

[4] Amendment No. 1 provides further justification and rationale for the PSE's proposed changes to the LMM Rule. Amendment No. 1 also provides revised language to the proposed Rule 6.82 changes. Letter from Michael D. Pierson, Senior Attorney, Regulatory Policy, PSE, to Michael A. Walinskas, Senior Special Counsel, Office of Market Supervision, Division of Market Regulation, Commission, dated August 9, 1996.

[5] Amendment No. 2, like Amendment No. 1, provides further justification and rationale for the PSE's proposed changes to the LMM Rule and provides revised language to the proposed Rule 6.82 changes. Letter from Michael D. Pierson, Senior Attorney, Regulatory Policy, PSE, to Janet Russell-Hunter, Special Counsel, Office of Market Supervision, Division of Market Regulation, Commission, dated September 26, 1996.

[6] The LMM Rule was adopted in January 1990 as a pilot program. *See* Securities Exchange Act Release No. 27631 (January 17, 1990), 55 FR 2462. The pilot program most recently was extended to September 30, 1997. *See* Securities Exchange Act Release No. 37767 (September 30, 1996).

[7] Current Rule 6.82(b)(3)(iii) provides that, subsequent to appointment of an issue to an LMM, the issue may be reassigned to the market maker system, pursuant to subsection (b)(7), once trading volume in the issue reaches an average daily volume of 3,000 contracts at the Exchange for four consecutive months, immediately preceded by an Exchange average of 75% of the total multi-exchange trading volume for three consecutive months. The Exchange is proposing to delete this provision and modify it as discussed below. It should be noted that both the provision being deleted and the one replacing it are permissive, not mandatory. *See* Amendment No. 1, *supra* note 4.

case of an issue traded by three or more options exchanges, the Exchange's share of the total multi-exchange customer trading in the issue drops from above 45% to below 45%, the Options Allocation Committee shall evaluate the LMM's performance in that issue, and, based on that evaluation, may reduce the LMM's guaranteed participation in the issue from 50% to 40%. *See* proposed Rule 6.82(d)(2)(A)–(B).

This proposed change is intended to give discretion to the Options Allocation Committee to reduce an LMM's guaranteed participation when trading volume levels are sufficiently high and the individual situation warrants such action. In making these determinations, the Options Allocation Committee would consider the factors specified in proposed Rule 6.83(e)(4) regarding evaluation of LMMs, including, among other things, consideration of the LMM's evaluation conducted pursuant to Options Floor Procedure Advice (''OFPA'') B–13, and the LMM's compliance with Exchange rules, including, but not limited to, Rules 6.32 through 6.40 and Article XI, Section 2 of the Exchange Constitution. The proposal would prompt the Options Allocation Committee to review the performance of LMMs when issues they trade have substantial increases in order flow.[8]

These new provisions assure LMMs that they will continue to retain some guaranteed participation as long as their performance is adequate. Thus, they serve as incentives to attract and keep qualified LMMs who will participate in the LMM Program and offer competitive markets and services. With respect to issues traded only on the Exchange, the Exchange believes that the Options Allocation Committee should have the flexibility to reduce an LMM's guaranteed participation in a high-volume issue from 50% to 25% if it finds, based upon review of an LMM's performance, that that issue has reached a high level of trading volume for reasons other than those for which the LMM is responsible.[9]

With respect to multiply-traded issues, the proposal would allow the Options Allocation Committee to take action in situations where an issue becomes heavily traded at the Exchange, but the Exchange begins to lose a certain share of order flow to a competing exchange.[10] In such situations, if the Options Allocation Committee finds that the LMM was responsible for the loss of order flow, it would have the ability to encourage better performance by reducing an LMM's guaranteed participation.[11]

The Exchange has selected the 40% and 25% figures (rather than other figures) because they take into account what the Exchange believes to be an appropriate balance of the factors that would be considered by the Options Allocation Committee in deciding whether to reduce an LMM's guaranteed participation. These factors include compensation to the LMM for taking on the responsibilities of an LMM,[12] and the amount of guaranteed participation necessary for the LMM to compete in multiple trading.[13]

With regard to the proposed change in the number of months (from four to three) that must pass before an LMM's guaranteed participation may be reduced, the Exchange seeks to accelerate the review process so that appropriate action may be taken more quickly.

2. Commentary .02 to Rule 6.82 currently provides that for an LMM to be used in any options class opened for trading at the Exchange before January 1, 1990, such option class must have an average monthly contract volume for the previous six-month period that ranks that class in the bottom 20% of class activity for the options floor. It further provides that any dually-traded options class whose daily contract volume for the previous calendar year falls below 70% of the total multi-exchange volume and any options class subject to reallocation pursuant to OFPA B–13 may be converted to the LMM Program at the discretion of the Exchange. The Exchange is proposing in Amendment No. 1 to eliminate Commentary .02 because the Exchange believes that all issues traded in the options floor should be eligible for trading under the LMM Program.[14] The Exchange believes that Commentary .02 is unnecessarily restrictive. To the extent that it precludes LMMs from trading high volume issues, the Exchange believes that it is unwarranted based on the Exchange's experience with several high-volume, multiply-traded issues that are, and have been, successfully traded under the LMM Program. The Exchange believes that there may be situations, other than those where reallocation currently is permissible, where reallocation to an LMM of a non-multiply-traded issue would be appropriate (*e.g.* where a trading crowd voluntarily requests an issue to be reallocated and an LMM offers to make better markets and to provide better customer service than any other applicant for the issue). Furthermore, the Exchange asserts that the current restrictions place the PSE at a competitive disadvantage to other exchanges. *See e.q.* CBOE Rule 8.80(a).[15]

The Exchange also is proposing to delete the reference to Commentary .02 in Rule 6.82(a)(2) because, under the proposal, Commentary .02 will be deleted.[16]

3. Under the proposal, if an issue is reallocated from an LMM to a market maker trading crowd, the market quality and service provided by the crowd must equal or better that previously provided or guaranteed by the LMM. Otherwise, the Options Allocation Committee may determine that the issue revert to the LMM system. *See* proposed Rule 6.82(f)(2).

4. The proposal would allow the Options Appointment Committee to designate a cooperative of market makers to act as an LMM in an issue provided the market makers in the cooperative together maintain a cash or liquid asset position in the amount required for LMM's, set forth in current Rule 6.82(c)(8).[17] A cooperative would consist usually of two or three Exchange members who must be registered as market makers. They may not, however, have ''financial arrangements'' with one another as defined in PSE Rule 6.40, which restricts such members from trading in the same trading crowd.[18] This provision further states that violations of the Exchange Constitution and Rules committed by a market maker cooperative that is not registered as a broker-dealer may render each market maker thereof personally liable for

[8] Amendment No. 1, *supra* note 4.

[9] Amendment No. 1, *supra* note 5.

[10] *Id.*

[11] The Options Allocation Committee could, of course, also reallocate the issue to another LMM or to the trading crowd pursuant to Rule 6.82(f)(1)(A) if the individual situation warranted such action.

[12] *See* Rule 6.82(c).

[13] The proposed reductions in guaranteed participation to 25% in exclusively-traded issues and to 40% in multiply-traded issues are based on the assumption that in multiply-traded issues, the LMM requires greater participation to compete for order flow with order exchanges.

[14] Amendment No. 1, *supra* note 4.

[15] Amendment No. 2, *supra* note 5.

[16] *Id.*

[17] Under the proposal, current Rule 6.82(c)(8) will be renumbered as Rule 6.82(c)(11) and will continue to require that an LMM maintain a cash or liquid asset position in the amount of $100,000 or in an amount sufficient to assume a position of 20 trading units of the security underlying the option the LMM has been allocated, whichever amount is greater.

[18] The PSE recently amended its Rule 6.40, Financial Arrangements of Options Floor Members (formerly, Financial Arrangements of Market Makers) in Securities Exchange Act Release No. 37543, (August 8, 1996), 61 FR 42458. *See also* Discussion section, *infra.* at notes 39–42 and accompanying text.

disciplinary sanctions for such violations.[19]

The Exchange believes that such cooperatives will serve a useful function by allowing for greater liquidity in an LMM issue together with greater accountability and service to customers than might otherwise be provided if only one member served as LMM in that issue.[20]

The Exchange believes that it is appropriate to allow such cooperatives to serve as LMMs so long as the capital requirements and customer service requirements of the LMM Rule are met, and the trading restrictions on members with financial arrangements are satisfied. If trading conditions were to become unduly complicated, however, the Options Allocation Committee could rectify the situation by disallowing more than one member to serve as LMM in that issue.[21]

5. The Exchange proposes that in the absence of extraordinary circumstances, as determined by the Options Allocation Committee, no LMM may be allocated more than 10% of the number of all option issues traded on the Options Floor. *See* proposed Rule 6.82(e)(3). The purpose of this proposed change is to reduce the Exchange's risk in the event that a member fails or a market break occurs and a number of option issues would then be required to be reallocated.[22]

6. The Exchange proposes to replace references to the LMM Appointment Committee in the current rule with references to either the Options Allocation Committee or the Options Appointments Committee. *See passim*. When Rule 6.82 first was adopted in 1990, it provided for the LMM Appointment Committee to administer virtually all of the provisions of the LMM Rule.[23] In June 1992, however, the Commission approved an Exchange proposal that, among other things, eliminated the LMM Appointment Committee, whose functions were assumed by the Options Allocation Committee and the Options Appointment Committee.[24] The current proposal conforms Rule 6.82 to Rules 11.10(a) and 11.10(c).[25]

Currently, and as specified in the rule change proposal, the Options Appointment Committee is responsible for ''qualifying'' LLMs, *i.e.*, approving their registration as LMMs based on capital requirements (and other factors). The Options Allocation Committee currently is responsible for allocating option issues to LMMs, evaluating LMM performance, and, if necessary, reallocating issues traded by LMMs. In addition, the Exchance notes that the Market Performance Subcommittee of the Options Floor Trading Committee currently is responsible for evaluating the performances of LMMs on a case by case basis when relevant issues arise, and making recommendations to the Options Allocation Committee on those issues.[26]

7. The proposal specifies that each LMM must designate an approved LMM to act as a substitute LMM (in case the designated LMM is unable to perform its duties), and notify Book Staff of such designation. *See* proposed Rule 6.82(c)(5). The term ''substitute LMM'' refers to a member who agrees to act for an LMM on a temporary basis when the registered LMM is unable to be present throughout a trading day. Substitute LMMs, agree to assume all of the registered LMM's duties as LMM. They must previously have been approved by the Options Appointment Committee and must currently meet all other requirements of the LMM Rule, including capital requirements.[27]

8. Rule 6.82(b)(8) currently provides that if an issue is reallocated pursuant to subsection (b)(7), the LMM shall receive an award of compensation based upon time of service, performance, capital commitment, and trading volume in the subject option issue. It further provides that this award shall not exceed two years. The Exchange proposes to change the term ''shall'' in that provision to ''may.'' *See* proposed Rule 6.82(f)(3). The Exchange believes that situations may arise where an issue is reallocated and the LMM should not be entitled to any compensation (*e.g.*, due to lack of performance). Given that the current rule is sufficiently vague that its requirements could be satisfied by providing an LMM with nominal compensation, the Exchange believes that the proposed change is relatively insignificant.[28]

In addition, in Amendment No. 1, the Exchange is proposing to change the reference to subsection (f)(2) contained in subsection (f)(4) to a reference to subsection (f)(1), because the Exchange notes that an award of compensation may be appropriate in any of the circumstances set forth in subsection (f)(1). The Exchange notes that under Amendment No. 1, subsection (f)(2) will be deleted.

9. The Exchange proposes to simplify the current provisions concerning appeals from Options Allocation Committee or Options Appointment Committee decisions so that in all cases such appeals are governed by Rule 11,[29] and, during such appeals, the Options Allocation Committee shall appoint an interim LMM or trading crowd until such appeal has been resolved. *See* proposed Rule 6.82(g). The Exchange believes that such decisions are not disciplinary in nature and that such appeals are more properly addressed by Rule 11 relating to appeals of committee decisions, rather than Rule 10, which relates to appeals of disciplinary decisions.

10. The proposal would remove a provision requiring that LMM issues be traded in an area of the trading floor that is separate from other issues. *See* current Rule 6.82(a)(2). The Exchange does not believe that segregated areas for market maker and LMM trading posts should be required because the integration of LMMs with market maker trading crowds allows for greater competition and liquidity. In addition, with the limited amount of space on the trading floor, the Exchange needs maximum flexibility when it is necessary to move an issue to a new location on the floor. The Exchange also intends to allow individual members to trade issues as LMMs while continuing to trade other issues as market makers in various locations on the floor.[30]

11. Proposed Rule 6.82(c)(2) states that each LMM is obligated to honor guaranteed markets, including markets required by Rule 6.86[31] and any better market pledged during the allocation process. The term ''better market pledged'' refers to the market depth or width that an applicant for a new issue agrees to provide if the Options Allocation Committee allocates that issue to that applicant. The Options Allocation Committee considers such pledges when choosing among applicants for allocations of new option issues. The rule change merely

[19] *See* proposed Rule 6.82(a)(3).

[20] Amendment No. 1, *supra* note 4.

[21] *Id*.

[22] *Id*.

[23] *See* Securities Exchange Act Release No. 27631, *supra* note 6.

[24] *See* Securities Exchange Act Release No. 20843 (June 19, 1992), 57 FR 28889 (approving File No. SR–PSE–92–07); *see also* PSE Rule 11.10(a) (Options Appointment Committee), Rule 11.10(c) (Options Allocation Committee), and OFPA B–13 (Evaluations of Options Trading Crowd Performance).

[25] Amendment No. 1, *supra* note 4.

[26] *Id*.

[27] *Id*.

[28] *Id*.

[29] PSE Rule 11 concerns generally committees of the Exchange. PSE Rule 11.7 concerns hearings and review of committee action.

[30] Amendment No. 1, *supra* note 4.

[31] PSE Rule 6.86 states that non-broker-dealer customer orders are entitled to a guaranteed minimum of twenty option contracts at the bid or offering prices being disseminated at the time the order is represented at the designated trading post.

reinforces the obvious requirements that LMMs must honor those pledges.[32]

12. The Exchange proposes to replace existing language in Rule 6.82(b)(10), which currently states that the ''Committee''[33] may perform all functions of the Market Performance Committee of the Board of Governors under the PSE rules with respect to review and evaluation of the conduct of LMMs in the classes of their LMM appointment. Instead, proposed Rule 6.82(e)(4) states that the Options Allocation Committee shall monitor and evaluate the performance of LMMs with regard to quality of markets. This will continue to be done at lease semiannually. In reviewing and evaluating an LMM's performance, the Options Allocation Committee will consider, among other things, OFPA B–13, and the LMM's compliance with Exchange rules, including, but not limited to, Rules 6.32 through 6.40 and Article XI, Section 2 of the Exchange Constitution. The Exchange notes that the reference to the Market Performance Committee should be deleted because that entity has been replaced by the Exchange's Board Oversight Committee.[34]

13. Rules 6.82(b)(4) and (b)(9)(ii) currently provide that an LMM who is the subject of ''Committee''[35] review in connection with the termination of an LMM appointment will be advised of the review and, upon receipt of such notification, shall have ten (10) business days in which to submit a written statement for the consideration of the Committee, and that formal rules of evidence do not apply to these proceedings.[36]

The Exchange proposes to delete this provision on the ground that it unnecessarily restricts the Options Allocation Committee, which may need to act promptly in reallocating issues, or the Options Appointment Committee, which may need to act quickly in disqualifying an LMM. The Exchange believes that these committees ought to have the ability to reallocate issues or disqualify LMMs in the normal course of business, and that no special procedures should be required, as is the case with virtually all other actions of committees.

14. In Amendment No. 1, the Exchange is proposing to modify Rules 6.82(b)(3) and 6.82(c)(13) so that members will be required to notify the Exchange, rather than specific committees (as stated in the original proposal), when certain events occur (*i.e.* notice of an LMM's resignation or notice of a material financial, operational or personnel change to the LMM). The Exchange believes that this change will make administration of the relevant rule provisions more efficient. The Exchange also is proposing to eliminate the phrase ''as determined by the Options Appointment Committee'' from the text of proposed Rule 6.82(f)(1)(B) because under that rule, determinations may be made either by the Options Appointment Committee or the Options Allocation Committee, depending upon the issue or circumstances. The Exchange will assure that any such notices will be forwarded to the appropriate Committee.

15. Rule 6.82(b)(7)(ii) currently provides that the use of an LMM in a particular option may be discontinued if ''it is * * * determined, considering all the facts and circumstances, that the trading in a particular option class would be better accommodated by the introduction of, or return to, the market maker system without an LMM. An LMM so affected shall be required to terminate his appointment in no fewer than three (3) business days subsequent to his receipt of written notice from the Exchange.'' The Exchange believes, based on its evaluation of the LMM Program over the past several years, that this vague provision is unnecessary for the operation of the LMM Program.[37]

16. In Amendment No. 1, the Exchange is proposing to modify OFPA B–13 to provide expressly that all of the rules and procedures applicable to the semiannual evaluations of options trading crowd performance will also apply to evaluations of LMM performance. This change would codify an existing practice of the Options Allocation Committee. As stated in the rule change, trading crowds are compared with other trading crowds and LMMs are compared with other LMMs for determining which trading crowds and which LMMs rank in the bottom 10% of the floor, thereby subjecting them to the remedial action specified in subsection (a) of OFPA B–13. In addition, the Exchange is proposing to modify subsection (i) of OFPA B–13 so that appeals of remedial action taken by the Options Allocation Committee will be governed by Rule 11.7 (''Hearing and Review of Committee Action''), rather than by Rule 10.11(d), which relates to appeals of disciplinary decisions.

17. The Exchange is proposing to eliminate the requirement in current Rule 6.82(c)(3) that the LMM disclose to the trading crowd the elements of any formula the LMM uses for automatically updating market quotations. The Exchange believes that this provision is unnecessary because the Exchange has a longstanding policy that any member who wants to know what formula is being used for automatically updating quotations in an issue can simply ask the Order Book Official, and he or she will provide the information to that member. The Exchange believes that this policy improves upon the existing rule, which is not specific as to when, or to whom the formula must be disclosed.

18. In Amendment No. 2, the Exchange is proposing to strike the words ''dually-traded or'' from Rule 6.82(d)(2)(A) because they are superfluous.[38] The Exchange also is replacing the term ''exclusively-traded'' in proposed Rule 6.82(d)(2)(B) with the term ''non-multiply-traded.''[39] Finally, the Exchange proposes to restructure the rule, eliminate superfluous provisions, and make other revisions that would clarify the current text of the Rule. *See passim*.

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 Section 6(b)(5) of the Act, in that the proposal is designed to protect investors and the public interest. The Commission finds generally that the proposed changes to the PSE's LMM Program may continue to enhance the market making mechanism at the PSE, thereby improving the market for listed options on the Exchange. Specifically, the Commission finds as follows:

1. The Commission believes that the Exchange's proposal to provide the Options Allocation Committee with the discretion to reduce an LMM's guaranteed participation in a dually- or multiply-traded issue from 50% to 40%, and, in a non-multiply-traded issue, from 50% to 25%, if certain volume levels are reached, is consistent with the Act.

The Commission agrees with the Exchange that once sufficient volume in an LMM issue has been developed it may be appropriate to undertake such action. The Commission also notes that with respect to multiply-traded issues,

[32] Amendment No. 1, *supra* note 4.

[33] Securities Exchange Act Release No. 30843, *supra* note 24.

[34] Amendment No. 1, *supra* note 4.

[35] Securities Exchange Act Release No. 30843, *supra* note 24.

[36] Amendment No. 1 *supra* note 4.

[37] *Id.*

[38] Amendment No. 2, *supra* note 5.

[39] *Id.*

the Exchange proposal would provide for such reductions only if the Exchange's share of trading volume fell below certain thresholds. The Commission notes that in making the determination whether to reduce an LMM's guaranteed participation, the Options Allocation Committee will consider factors such as the LMM's evaluation conducted pursuant to OFPA B–13, and the LMM's compliance with Exchange rules, including, but not limited to, Rules 6.32 through 6.40 and Article XI, Section 2 of the Exchange Constitution.[40] The Commission also notes that these provisions are permissive, not mandatory.

The Commission finds that the distinction the Exchange makes between multiply-traded issues and non-multiply-traded issues is reasonable. As noted by the Exchange, this distinction, is intended to provide an LMM with greater participation for multiply-traded issues, given that it will be competing for order flow with other exchanges. As further noted by the Exchange, when an issue traded only on the Exchange reaches a high level of trading volume, there should be flexibility to reduce the LMM's guaranteed participation where the issue has reached high trading volume for reasons other than those attributable to LMM performance.

The Commission also finds that the change from four to three as the number of months that must pass before an LMM's guaranteed participation may be reduced is reasonable given that it will permit appropriate action to be taken more quickly.

2. Commentary .02 to Rule 6.82 currently restricts the use of an LMM to various options classes. The Exchange is proposing to make all issues traded on the options floor eligible for the LMM Program. The Commission notes that in the original proposal for the LMM Program, the Exchange made eligible new options classes, and those with comparatively low volume.[41] The Exchange believes that Commentary .02 is unnecessarily restrictive based on its successful experience trading several high-volume, multiply-traded issues in the LMM Program. The Commission finds that it is appropriate to open the LMM Program to all issues traded on the options floor because the broadening of the LMM Program may enhance the market making mechanism on the Exchange, thereby improving the markets for all listed options on the Exchange. Specifically, the Commission believes that expanding the LMM Program may improve the Exchange's market making capabilities by encouraging long-term commitments to options classes.

The Commission notes that the pilot LMM Program recently was extended for another year, and will expire in September 1997.[42] In approving the modification to the LMM Program making all option issues eligible, the Commission notes, however, that before the LMM Program can be approved on a permanent basis, or further extended, the Exchange must provide the Commission with an updated report on the operation of the LMM Program.[43] When the Commission receives this report, it will consider the impact of this modification in deciding whether to approve the LMM Program on a permanent basis, or to further extend it.

3. The Commission believes that, if an issue is reallocated from an LMM to a market maker trading crowd, it is reasonable that the Exchange require that the market quality and service equal or better that previously provided or guaranteed by the LMM. The Commission notes that under the proposal the Options Allocation Committee is not required to reallocate the issue to the LMM system. The Commission believes that it is consistent with the Act to allow the Options Allocation Committee to take such action because it should result in options being reallocated in a manner designed to achieve improved market quality and service.

4. The Commission believes that the Exchange's proposal to allow the Options Appointment Committee to designate a cooperative of market makers to act as an LMM in an issue is consistent with the Act. The Exchange states that it believes that such cooperatives should serve to increase liquidity in an LMM issue and provide for better service to customers than might otherwise exist. In addition, PSE Rule 6.40 should address concerns that may exist that a market maker cooperative might dominate the market in a given issue.[44] Rule 6.40 provides that a member with a ''financial arrangement''[45] with another member may not bid, offer, and/or trade in the same trading crowd at the same time in the absence of an exemption from the Options Floor Trading Commission.[46] The Commission expects that, as would generally be the case, in determining whether a market maker cooperative should to receive an exemption from the Rule 6.40 restrictions, the Options Floor Trading Committee will consider the potential for market domination the market maker cooperative could pose. The Commission notes that, in addition to a cooperative meeting the Exchange's capital requirements, each member of a cooperative of market makers that is acting as an LMM must comply with Rule 15c3–1 under the Act, the net capital rule.[47]

5. The Commission finds that the Exchange's proposal to prevent a single LMM from being allocated more than 10% of the number of option issues traded on the options floor is consistent with the Act. The Commission agrees with the Exchange that this provision should help to address concerns regarding the potential adverse effects on the maintenance of a fair and orderly market that could arise from a LMM's insolvency or similar event.

6. The Commission finds that the Exchange's proposal to replace references to the LMM Appointment Committee that exist in the current rule with references either to the Options Allocation Committee or the Options Appointment Committee is appropriate given that the LMM Appointment Committee no longer exists.[48] The Commission believes that this aspect of the Exchange's proposal should add clarity to the LMM Rule.

7. The Commission believes that the Exchange's proposed requirement that each LMM designate an approved LMM to act as a substitute LMM is reasonable and should serve to benefit the LMM system by ensuring that the duties of an LMM absent on a particular day nevertheless will be undertaken by another LMM.

8. The Exchange has proposed to permit, rather than require, the awarding of compensation to an LMM whose issue is reallocated pursuant to proposed Rule 6.82(f)(1). The Commission finds that it is appropriate for the Exchange to determine what compensation, if any, an LMM should receive in the event of reallocation of an issue.

9. The Commission believes that the Exchange's proposal to have all appeals

[40] Amendment No. 1, *supra* note 4.

[41] Securities Exchange Act Release No. 27631, *supra* note 6.

[42] Securities Exchange Act Release No. 37767, *supra* note 6.

[43] *Id.*

[44] The purpose of Rule 6.40 is to prevent market makers who have financial arrangements with each other from unfairly dominating the market in any option issues or series. PSE Rule 6.40, Commentary .01. The Commission recently approved certain changes to PSE Rule 6.40. Securities Exchange Act Release No. 37543, *supra* note 18.

[45] PSE Rule 6.40(a), Financial Arrangements Defined.

[46] PSE Rule 6.40(b)(1). PSE Rule 6.40 formerly imposed a narrower restriction on market makers with financial arrangements with floor brokers. Former PSE Rule 6.40, Commentary .01.

[47] 17 CFR 240.15c3—1.

[48] *See* Securities Exchange Act Release No. 30843, *supra* note 24.

from Options Allocation Committee or Options Appointment Committee decisions be governed by Rule 11 rather than Rule 10 is appropriate given that Rule 10 concerns disciplinary proceedings and appeals, whereas Rule 11 concerns committees of the Exchange. The Commission agrees with the Exchange that because decisions of the Options Allocation Committee and the Options Appointment Committee are not disciplinary in nature, they more properly are addressed by Rule 11.

10. The Exchange has proposed to remove the provision requiring LMM issues be traded in an area of the trading floor that is separate from other issues. The Commission believes that this restriction is not necessary, and agrees with the PSE that removing it will afford the PSE increased flexibility in allotting limited space, and similarly will allow PSE members to trade issues as LMMs while continuing to trade other issues as market makers.

11. The Commission agrees with the PSE that the provision that an LMM honor any ''better markets pledged during the allocation process'' reinforces and serves to formalize the implicit requirement that an LMM honor pledges made during the allocation process, and therefore is reasonable.

12. The Commission believes that the Exchange's proposal to replace a reference to ''Committee'' with one to Options Allocation Committee is appropriate given that ''Committee'' in current Rule 6.82 refers to the LMM Appointment Committee which no longer exists.[49] Similarly, the current reference to Market Performance Committee, now the Board Oversight Committee, is removed. The Commission believes that both these changes add clarity to the Exchange's proposal.

13. The Exchange proposes to remove the current provision that states that an LMM that is the subject of Committee review in connection with the termination of an LMM appointment shall have ten business days in which to submit a written statement for the consideration of the Committee. The Exchange has stated that this provision unnecessarily restricts the Options Appointment Committee and the Options Allocation Committee, which may need to act promptly to disqualify an LMM or to reallocate issues, as the case may be. Moreover, the Exchange states that the Options Allocation Committee should be able to effect reallocation in the normal course of its business, and that no special procedures should be required, given that other actions of committees require no such special procedures.

The Commission believes that this aspect of the Exchange's proposal is appropriate, given that it would allow the Options Appointment Committee to disqualify an LMM due to a material financial, operational, or personnel change warranting immediate action, and furthermore, would permit the Options Allocation Committee to reallocate issues promptly. A ten day notification period is at odds with such a need for prompt action. The Commission finds that the removal of the ten day notice provision is consistent with the Act. Furthermore, the Commission finds that the elimination of this provision is consistent with appeals from Options Allocation Committee or Options Appointment Committee decisions being governed by Rule 11[50] concerning committees of the Exchange.

14. The Commission agrees that requiring members to notify the Exchange, rather than a specific committee, when certain events occur, such as notice of an LMM's resignation or notice of a material financial, operational, or personnel change to the LMM, will make administration of the relevant rule provisions more efficient. The Commission also agrees that deletion in Rule 6.82(f)(1)(B) of the phrase ''as determined by the Options Appointment Committee'' is appropriate, where determination of whether a material change in the LMM's operations or status has occurred may be made, depending on the circumstances, by either the Options Appointment Committee or the Options Allocation Committee.

15. The Commission believes that the proposal to delete the provision in current Rule 6.82(b)(7)(ii) requiring an LMM to terminate his appointment within three business days of written notification by the Exchange of a determination that trading in a particular option would be better accommodated by the introduction of, or return to, the market maker system without an LMM, is appropriate. The Commission agrees with the Exchange that the provision is vague, and notes that Rule 6.82 contains more specific provisions for the reallocation of a particular option of another LMM or to the market maker trading crowd.[51]

16. The Commission believes that the modification of OFPA B–13 to provide expressly that all of the rules and procedures applicable to the semiannual evaluations of options trading crowd performance will also apply to evaluations of LMM performance is appropriate. The Commission agrees that this modification is appropriate as the codification of existing practice of the Options Allocation Committee, and that it creates consistency in the treatment of LMMs and options trading crowds with respect to evaluations.

The Exchange also is proposing to modify OFPA B–13 so that appeals of remedial action taken by the Options Allocation Committee will be governed by Rule 11 rather than Rule 10. The Commission believes this modification is consistent with the Exchange's proposal that appeals of decisions from the Options Allocation Committee and the Options Appointment Committee will be governed by Rule 11 concerning appeals of committee decisions, rather than Rule 10 concerning appeals of disciplinary decisions.

17. The Commission finds that the elimination of the requirement to disclose to the trading crowd the formula used by the LMM to automatically update market quotations is appropriate in light of the longstanding Exchange policy, that this information is available upon request from the Order Book Official. The Commission considers the provision requiring LMM disclosure of this information therefore to be superfluous and unnecessary.

18. The Commission finds appropriate the revisions to the proposal that would strike the words ''dually-traded or'' from Rule 6.82(d)(2)(A) because they are superfluous, and replace the term ''exclusively-traded'' in proposed Rule 6.82(d)(2)(B) with the term ''non-multiply-traded.'' The Committee finds that the other revisions and restructurings to Rule 6.82 serve to add clarity to the Exchange's proposal, and therefore are appropriate.

19. The Commission finds good cause for approving Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Amendment Nos. 1 and 2 consist of clarifying changes that serve to strengthen the Exchange's proposal, but do not materially alter the terms of the proposal as originally described when published for comment.[52] Accordingly, the Commission believes there is good cause, consistent with Sections 6(b)(5) and 19(b)(2) of the Act, to approve

[49] *Id.*

[50] *See* PSE Rule 11.7 (concerning hearings and review of committee action).

[51] *See* current Rule 6.82(b)(4); proposed Rule 6.82(f).

[52] Securities Exchange Act Release No. 36952, *supra* note 3.

Amendment Nos. 1 and 2 to the proposal on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 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–96–03 and should be submitted by October 31, 1996.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[53] that the proposed rule change (SR–PSE–96–03), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[54]

Jonathan G. Katz,

Secretary.

[FR Doc. 96–26013 Filed 10–9–96; 8:45 am]

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[53] 15 U.S.C. 78s(b)(2) (1988).

[54] 17 CFR 200.30–3(a)(12).

[Release No. 34–37781; File No. SR–PSE–96–16]

Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to Listing and Trading Guidelines for Municipal Bonds

October 3, 1996.

On June 5, 1996, the Pacific Stock Exchange, Inc. (''PSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt on a permanent basis rules for the listing and trading of municipal bonds.

Notice of the proposed rule change was published for comment and appeared in the Federal Register on July 9, 1996.[3] No comments were received on the proposal. On October 1, 1996, PSE submitted Amendment No. 1 (''Amendment No. 1'') to the proposal to adopt additional maintenance criteria.[4] This order approves the proposal, as amended.

I. Description of the Proposal

On March 7, 1994, the Commission approved an Exchange pilot program providing for the listing and trading of ''municipal securities,'' as defined in Section 3(a)(29) of the Act (''pilot program'').[5] The Exchange now proposes to adopt this municipal securities pilot program on a permanent basis.

Under the pilot program, and municipal security may be eligible for Exchange listing provided it is rated as investment grade by at least one nationally recognized rating service, and satisfies the Exchange's distribution criteria for bonds of issuers whose corporate securities are not listed on the Exchange, *i.e.*, the size of issue must be at least $20 million principal amount/aggregate market value, with at least 100 holders. In addition, the Exchange may consider such other information as it deems necessary to evaluate the appropriateness of the issue for exchange trading, including the financing structure and/or arrangement of the issuer.

Any municipal securities listed by the Exchange must be assigned to a specialist and traded in accordance with all PSE regulations otherwise applicable to the trading of securities listed on the Exchange. As with corporate bonds, trade reports and quotation information for municipal securities will be disseminated over Network B. However, to ensure uniformity of practice within the securities industry, proposed Rule 5.13(i) provides that all aspects of the trade reconciliation process, including comparison, settlement and clearing will be governed by the applicable requirements of the Municipal Securities Rulemaking Board (''MSRB'').[6]

Under the pilot program, any purchase or sale of a municipal security shall be exempt from the provisions of the Exchange's off-board trading rules.[7] In addition, the pilot program is not intended to otherwise alter the existing regulatory framework and oversight applicable to municipal securities trading.[8] Finally, a municipal security would be subject to delisting in the event it were no longer rated as investment grade by a nationally recognized rating service.

To accommodate the listing of municipal securities, the PSE proposes to apply the same rules and conditions of the pilot program, as noted above, on a permanent basis. In addition, the Exchange proposes to adopt the following rules on a permanent basis: Rule 3.2(e)(3) (basic listing requirements); Rule 3.5(d)(5) (maintenance requirements);[9] Rule 5.13(i) (comparance, settlement, and clearance); and Rule 5.46(xv) (exemption to off-board trading requirements).

The Exchange proposes that any municipal security that it lists be assigned to a specialist and traded in accordance with all PSE regulations otherwise applicable to the trading of securities on the Equity Floors of the Exchange.[10] Finally, the Exchange represents that it will require that its members who trade municipal bonds listed on the Exchange will have an adequate understanding of the tax

[1] 15 U.S.C. 78s(b)(1) (1988 & Supp. V 1993).

[2] 17 CFR 240.19b–4 (1994).

[3] *See* Securities Exchange Act Release No. 37385 (June 28, 1996), 61 FR 36099.

[4] Letter from Michael Pierson, PSE, to Stephen M. Youhn, SEC, dated September 30, 1996.

[5] *See* Securities Exchange Act Release No. 33721 (March 7, 1994), 59 FR 11636 (March 11, 1994). On July 5, 1994, the Commission approved a 120-day extension to the Exchange's Municipal Bond Trading Pilot Program. *See* Securities Exchange Act Release No. 34317 (July 5, 1994), 59 FR 35546 (July 12, 1994). The pilot program expired in November 1994.

[6] MSRB Rule G–3 provides specific qualification requirements for municipal securities principals and representatives. In light of the PSE's qualification requirements for specialists, the Exchange believes it is appropriate for the PSE to rely on these requirements for its specialists in lieu of the Rule G–3 standards. It is important, however, that any specialist selected by the PSE for a listed municipal security be familiar with the characteristics of municipal securities.

[7] *See* Rule 5.46.

[8] The National Association of Securities Dealers (''NASD'') has the authority to enforce the MSRB rules. The Exchange notes that it will also be responsible for enforcing MSRB rules for the listed municipal securities. The PSE's enforcement in this regard will not preempt or limit in any manner the NASD's authority to act in this area.

[9] In addition to requiring a particular issue to be rated as investment grade by at least one nationally recognized rating service, PSE will require the issue to have a market value or principal amount outstanding of at least $400,000. *See* Amendment No. 1. The Commission also notes that PSE Rule 3.5(s), which sets forth reasons for suspending or delisting a security, will also apply to municipal securities.

[10] To date, the Exchange has not listed or traded any municipal securities under the pilot program.