

Commission has approved the proposals for a two-year pilot period. The Exchanges will undertake to monitor, among other things, open interest and potential adverse market effects and to report to the Commission on the status of the program no later than eighteen months after the order's date of effectiveness. The reporting of the Exchanges' experiences should include, among other things, such information as: (i) The type of strategies used by FLEX Equity options market participants and whether FLEX Equity options are being used in lieu of existing standardized equity options; (ii) the type of market participants using FLEX Equity options both before and during the pilot program, including how the utilization of FLEX Equity options has changed; (iii) the average size of the FLEX Equity option contract both before and during the pilot program, the size of the largest FLEX Equity option contract on any given day both before and during the pilot program, and the size of the largest FLEX Equity option held by any single customer/member both before and during the pilot program; and (iv) any impact on the prices of underlying stocks during the establishment or unwinding of FLEX positions that are greater than three times the standard position limit. Finally, the Commission expects the Exchanges to take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in component stocks, should any unanticipated adverse market effects develop.

The Commission finds good cause to approve Amex Amendment No. 1 and CBOE Amendment No. 1 to the proposed rule filings prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, by restricting the elimination of position and exercise limits for FLEX Equity options to a two-year pilot period, as well as requiring members holding large positions to report such positions to the Amex and to the CBOE, the proposed rule changes are more restrictive than the original proposals, which are published for the entire twenty-one day comment period and generated no responses. In addition, by authorizing the Amex and the CBOE to impose margin and/or assess capital charges, the Commission believes that the Amex and the CBOE have established important safeguards to address concerns regarding potential manipulation or other market disruptions. Accordingly, the

Commission believes that it is consistent with Section 6(b)(5) of the Act to approve Amex Amendment No. 1 and CBOE Amendment No. 1 to the proposed rule changes on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning Amex Amendment No. 1 and CBOE Amendment No. 1 to the rule proposals. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule changes 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 at the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filings also will be available for inspection and copying at the principal offices of the Amex and the CBOE. All submissions should refer to File Nos. SR-Amex-96-19 and SR-CBOE-96-79 and should be submitted by October 7, 1997.

#### V. Conclusion

For the foregoing reasons, the Commission finds that the Exchanges' proposals to eliminate position and exercise limits for FLEX Equity options for a two-year pilot period, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>17</sup> that the proposed rule changes (SR-Amex-96-19), SR-CBOE-96-79 and SR-PCX-97-09), as amended, are approved on a pilot basis until September 9, 1999.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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<sup>17</sup> 15 U.S.C. 78s(b)(2) (1988).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39035; File No. SR-Amex-97-10]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the American Stock Exchange, Inc. Relating to Amendments to Rule 170.01 Relating to Specialists Establishing a Position in Specialty Stocks

September 9, 1997.

#### I. Introduction

On February 24, 1997, the American Stock Exchange, Inc. ("Amex" 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 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> the proposed rule to change to permit specialists to engage in certain types of transactions by removing existing restrictions that currently limit specialists approval when establishing or increasing a position in their specialty stocks.<sup>3</sup> Notice of the filing appeared in the **Federal Register** on May 12, 1997.<sup>4</sup> No comment letters were received concerning the proposed rule change. This order approves the Amex's proposal.

#### II. Description of the Proposal

The Amex, pursuant to Rule 19b-4 of the Act, proposes to amend Amex Rule 170.01 ("Rule") to remove certain restrictions on specialists' ability to establish or increase their positions in their specialty stocks.

##### *Purpose*

Amex Rule 170 governs specialists' dealings in their specialty stocks. In particular, Amex Rule 170.01 describes certain types of transactions to establish or increase a specialist's position which are not to be effected unless they are "reasonably necessary to render the specialist's position adequate to" the needs of the market. Additionally, these types of transactions require floor official approval unless they are conducted in "less active markets" where such transactions are an essential part of a proper course of dealings and where the amount of stock involved and the price change, if any, are normal in relation to the market.<sup>5</sup> Currently, such

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 38573 (May 5, 1997).

<sup>4</sup> FR 25984 (May 12, 1997).

<sup>5</sup> See Amex Rule 104.10(5)(i).

restrictions apply equally to transactions that are beneficial to the market by being against the market trend and those that are disadvantageous to the market by being with the market trend. The Exchange is proposing to apply these restrictions only to those transactions that are disadvantageous to the market by being with the market trend.

Specifically, Amex Rule 170 provides that a specialist is affirmatively required to engage in a course of dealings for his own account to minimize order disparities and contribute to continuity and depth in the market, and is precluded from trading for his own account unless such dealing is necessary for the maintenance of a fair and orderly market. The price trend of a security should thus be determined by incoming orders rather than the specialist's proprietary dealings.

Commentary .01 to Amex Rule 170 sets forth specific requirements which are applicable when a specialist is establishing or increasing a position, and provides that a specialist should effect such transactions in a reasonable and orderly manner in relation to the condition of the general market, the market in the particular stock and the adequacy of his position to meet the immediate and reasonably anticipated needs of the market. In particular, Amex Rule 170.01(a) prohibits a specialist from purchasing stock at a price above the last sale in the same trading session, without Floor Official approval. Amex Rule 170.01(b) provides that a specialist must obtain Floor Official approval prior to effecting the purchases of all or substantially all the stock offered on the book at a price equal to the last sale, when such offer represents all or substantially all the stock offered in the market. Amex Rule 170.01(c) provides that a specialist similarly must obtain Floor Official approval prior to supplying all or substantially all the stock bid for on the book at a price equal to the last sale. Amex Rule 170.01(d) requires the specialist to re-offer or re-bid where necessary after effecting the transactions described in paragraphs (a), (b) and (c) of the Rule.

The Amex states that the restrictions contained in paragraphs (b) and (c) of the Rule were intended to strike a balance between protecting the auction market from unnecessary specialist trading and providing immediate liquidity to orders that come to the Floor. The Floor Official's function, at the time Rule 170 was adopted, was to operate as a control mechanism to ensure that the specialist did not trade unnecessarily.

The Amex contends that although the need to obtain Floor Official approval was reasonable in the past, before technology enabled markets to move quickly within seconds, it now has the effect, under certain circumstances, of reducing liquidity and disadvantaging orders entered with the specialist. Accordingly, the Exchange proposes to amend Amex Rule 170.01 to provide that a specialist is not required to obtain Floor Official approval with respect to the purchase, on a zero minus tick, of stock offered on the book, or the sale, on a zero plus tick, of stock bid for on the book. A specialist is the buyer and seller of last resort, and is expected to step in when there is a disparity between supply and demand. In this situation, the Amex contends that a specialist would only be purchasing the stock offered because there is inadequate demand for the stock.

In addition, the Amex contends that with the advent of improved technology, the Exchange's surveillance systems can now provide an adequate substitute for Floor Official Approval in such circumstances. In the last few years, the Exchange has developed an automated computer program which identifies each instance in which a specialist crosses the market (i.e., buys on the offer and sells on the bid). Each of these situations can then be individually reviewed by the Exchange Trading Analysis staff to determine whether the specialist was acting appropriately. With respect to the proposed rule change, the Exchange staff would look at how large the specialist's position was prior to the transaction, whether there were imbalances in the limit orders on the specialist's book which necessitated the transaction, and whether, if the market subsequently "turned around" the specialist used a reasonable amount of the inventory acquired in the transaction to offset any imbalance between supply and demand.

The Amex believes that the proposed change carves out an exception to the existing provisions, but would provide a distinct benefit to the market by permitting the specialist to satisfy a customer's order more expeditiously, while enabling the specialist to enhance the liquidity, depth and transparency of the market as the buyer or seller of last resort.

### III. Commission Findings 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, with Section 6(b)(5) of the Act.<sup>6</sup> The Commission believes the proposal is consistent with the Section 6(b)(5) requirements that the rules of an exchange be designed to promote just and equitable principals of trade, remove impediments to and perfect the mechanism of a free and open market, and, in general, protect investors and the public interest, promote efficiency, competition and capital formation.<sup>7</sup> The Commission also believes that the proposal is consistent with Section 11(b) of the Act and Rule 11b-1 thereunder,<sup>8</sup> which allow exchanges to promulgate rules relating to specialists in order to maintain fair and orderly markets.

Both the Act and Amex Rules reflect the crucial role played by specialists in providing stability, liquidity and continuity in the Exchange's auction market. Recognizing the importance of the specialist in the auction market, the Act and Amex Rules impose stringent obligations upon specialists.<sup>9</sup> Primary among these obligations are the requirements to maintain fair and orderly markets and to restrict specialist dealings to those that are "reasonably necessary" in order to maintain a fair and orderly market.<sup>10</sup>

The importance of specialist performance to the quality of markets was highlighted during the 1987 and 1989 market breaks. In The October 1987 Market Break Report ("1987 Report"), the Division examined specialist performance on the Amex on October 19 and 20, 1987.<sup>11</sup> The Division found that, during periods of the greatest volatility in 1987, particularly on October 19, 1987, Amex specialists had to act as the primary, or sometimes the only, buyers for many of the specialty stocks because of the lack of buying interest by upstairs firms.<sup>12</sup> The increased volume of order flow, coupled with the lack of participation on the part of the upstairs firms, resulted in Amex specialists having to take large dealer

<sup>6</sup> 15 U.S.C. 78f.

<sup>7</sup> 15 U.S.C. 78(c).

<sup>8</sup> 15 U.S.C. 78k and 17 CFR 240.11b-1(a)(2).

<sup>9</sup> Rule 11b-1 under the Act, 17 CFR 240.11b-1 and Amex Rule 170.

<sup>10</sup> 17 CFR 240.11b-1(a)(2).

<sup>11</sup> See 1987 Report, February 1988 at xvii, 4-1.

<sup>12</sup> See 1987 Report 4-23 to 4-24 and 4-26, to 4-27. Generally, "upstairs firms," or block trading desks of large broker dealers (as opposed to specialists and other traders on the Amex Floor), can, at times, provide an additional source of liquidity for Amex-listed issues through their trading activities. During the 1987 market break, however, particularly on October 19, 1987, very little buying was effected by upstairs firms, forcing specialists to be the contra-side to large blocks of stock.

positions.<sup>13</sup> Although many Amex specialists appeared to perform well under the adverse conditions, specialist performance during this period varied widely.

The Division also examined Amex specialist performance during the volatile conditions of October 13 and 16, 1989. The Division found that specialist performance during that time was similar in many respects to specialist performance during the 1987 market break.<sup>14</sup> Specifically, the Division found that, during these two periods of extreme market volatility, specialists were confronted with extraordinary order imbalances that required unprecedented capital commitments.<sup>15</sup> As in October 1987, specialists as a whole on October 13, 1989 were substantial buyers in the face of heavy selling pressure, although performance varied among specialists.

Both the 1987 Report and the 1989 Analysis reaffirmed the importance of specialist participation in countering market trends during periods of market volatility. At the same time, the reports emphasized the importance the Commission placed on the Amex's ability to ensure that all specialists comply with their affirmative and negative market making obligations during such periods.<sup>16</sup>

The Commission recognizes that market conditions may exist at times where it is necessary or desirable to provide specialists with additional flexibility in establishing or increasing a position in order to facilitate their ability to maintain fair and orderly markets, particularly during unusual market conditions. Accordingly, the Commission believes that it is appropriate for the Amex to remove those provisions of Rule 170.01 that require floor official approval for certain specialist purchases on zero-minus ticks and specialist sales on zero-plus ticks.<sup>17</sup>

<sup>13</sup> See 1987 Report at 4-48.

<sup>14</sup> See Market Analysis of October 13 and 16, 1989 ("1989 Analysis") at 3-4 and 33-44.

<sup>15</sup> See 1987 Report at 4-8 and 1989 Report at 23-26.

<sup>16</sup> A specialist's dealer responsibilities consist of "affirmative" and "negative" obligations. In accordance with their affirmative obligations, specialists are obligated to trade for their own accounts to minimize order disparities and contribute to continuity and depth in the market. Conversely, pursuant to their negative obligations, specialists are precluded from trading for their own accounts unless such dealing is necessary for the maintenance of a fair and orderly market. In view of these obligations, the price trend in a security should be determined not by specialist trading but by the movements of the incoming orders that initiate these trades.

<sup>17</sup> The Commission notes that Rule 170.01 currently only requires floor official approval for purchases or sales at a price equal to the last sale price when all or substantially all the stock offered/

The proposed changes may allow specialists, during periods of market volatility, to keep any general price movements orderly, thereby furthering the maintenance of fair and orderly markets consistent with Sections 6 and 11 of the Act. The Commission emphasizes, however, that the expanded flexibility afforded to specialists by the proposal merely obviates the current required floor official approval for the affected transactions and does not reflect that all specialist purchases on zero-minus ticks and sales on zero-plus ticks are appropriate. Notably, specialists remain subject to their "negative obligations," specifically, the requirement that specialists are precluded from trading for their own account unless such dealing is necessary for the maintenance of a fair and orderly market.<sup>18</sup>

Finally, the Commission believes that the Amex's established surveillance procedures and criteria, including the automated computer program which identifies each instance in which a specialist crosses the market, should allow the Exchange to monitor specialist compliance with Amex Rule 170.01. In addition, the Commission expects the Amex to monitor carefully compliance with the procedures of Amex Rule 170 as required under Section 19(g) of the Act.<sup>19</sup>

For the foregoing reasons, the Commission finds that the Amex's proposal to permit specialists to engage in certain types of transactions by removing existing restrictions that currently limit specialists when establishing or increasing a position in their specialty stocks is consistent with the requirements of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-Amex-97-10), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

bid on the limit order book represents all or substantially all the stock offered/bid in the market. Moreover, the rule currently does not require floor official approval of such transactions if they are effected in "less active markets" where they are an essential part of a proper course of dealings and where the amount of stock involved and the price change, if any, are normal in relation to the market.

<sup>18</sup> In addition, Amex Rule 170.01 clearly requires that covered transactions must be reasonably necessary to render the specialist's position adequate to such needs.

<sup>19</sup> Section 19(g) of the Act requires every self-regulatory organization to comply with, and enforce compliance with, the Act, the rules thereunder and its own rules.

<sup>20</sup> 17 CFR 200.30-3(a)(12).

Margaret H. McFarland,

Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39033; File No. SR-NASD-97-62]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Gross Income Assessments to Member Firms

September 9, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on August 22, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organizations' Statement of the Terms of Substance of the Proposed Rule Change

The NASD is proposing a rule change to amend Section 1(c) to Schedule A of the NASD By-Laws ("Schedule A") to revise the credit allowed to members against the annual assessment on their gross income. The text of the proposed rule change is below. Additions are italicized; deletions are bracketed.

\* \* \* \* \*

#### Schedule A to the NASD By-Laws

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of the Corporation, shall be determined on the following basis.

#### Section 1—Assessments

Each member shall pay an annual assessment composed of:

(a) No Change.

(b) No Change.

(c) Members shall receive a credit against the annual assessment on gross income stated in paragraph (a) above as follows:

(1) Portion of assessment > \$5,000 —  
21% [23%]

(2) Portion of assessment > \$25,000 —  
3% [4%] additional

<sup>1</sup> 15 U.S.C. 78s(b)(91) (1994).