

by eliminating the provisions which create the apparent inconsistency.

Some commentators asserted that communications with the public should be uniform among all broker/dealers if eliminating customer confusion is truly the NASD's goal.¹⁰⁰ The NASD agrees and believes the proposed rule change advances that goal.

D. Financial Institution Logos. While the proposed rule change does not specifically address the issue of the use of financial institution logos in advertisements and sales literature, several commentators, including the FRB, asked the NASD to clarify its position on the use of financial institution logos by NASD members to dispel any confusion about the permissibility of using financial institution holding company family logos. The FRB urged the NASD to permit the broker/dealer to use an affiliated financial institution logo to advertise its services.¹⁰¹ Subsequent to the publication of Notice to Members 94-94, the NASD issued Notice to Members 95-49 to clarify its previous statements on the use of logos of financial institutions in advertisements and sales literature of members in a manner consistent with the Chubb Letter. The Notice stated that the logo of a non-member (representative only of the non-member) may only be used in member communications to identify the non-member entity.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The NASD consents to an extension of the time for Commission action to 30 days from the end of the comment period specified in Item IV below. At such time, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. 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

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 Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by May 21, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰²

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-36981; File No. SR-PSE-95-28]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1, 2, and 3 to the Proposed Rule Change by the Pacific Stock Exchange, Inc., Relating to Establishing a Hedge Exemption for Narrow-Based Index Options

March 15, 1996.

On November 1, 1995, the Pacific Stock Exchange, Inc. ("PSE" 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"),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend PSE Rule 7.6, "Position Limits for Index Options," to establish a hedge exemption from industry (narrow-based) index option position and exercise limits.³

The proposed rule change was published for comment in the Federal Register on December 6, 1995.⁴ On January 31, 1996, on February 29, 1996,

and on March 15, 1996, the PSE amended its proposal.⁵ No comments were received on the proposed rule change.

The PSE proposes to amend its rules to provide that industry index option positions may be exempt from established position and exercise limits for each contract "hedged" by an equivalent dollar amount of the underlying component securities or securities convertible into such components, provided that each option position to be exempted is hedged by a position in at least 75% of the number of component securities underlying the index, and that the underlying value of the option position does not exceed the value of the underlying portfolio. The value of the portfolio is: (a) The total market value of the net stock position, less (b) the value of (1) any offsetting calls and puts in the respective index option; (2) any offsetting positions in related stock index futures or options; and (3) any economically equivalent positions.⁶ The values of any such index option position or related futures position are determined by aggregating the notional value⁷ of each option contract comprising the position. Under the proposed exemption, position and exercise limits for any hedged industry

⁵ On January 31, 1996, the PSE amended its proposal to indicate that the requirements of subsections (a), (b), (c), (f), (g), (h), and (i) of Commentary .02, "Broad-Based Index Hedge Exemption," will apply to narrow-based index option hedge exemptions. In addition, the PSE clarified its rules by indicating that exercise limits will correspond to position limits under both the narrow-based and broad-based index hedge exemptions. Finally, the PSE stated that whenever the Exchange grants a narrow-based index option hedge exemption, it will monitor the equity position used as a hedge on a daily basis. See Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, Office of Market Supervision ("OMS"), Division of Market Regulation ("Division"), Commission, dated January 30, 1996 ("Amendment No. 1"). On February 29, 1996, the PSE amended its proposal to indicate that economically equivalent positions must be deducted from the market value of the net stock position in order to determine the value of the underlying portfolio. The amendment also provides examples of the number of contracts that a market participant may hold and exercise pursuant to the exemption. See Letter from Michael Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, OMS, Division, Commission, dated February 29, 1996 ("Amendment No. 2"). On March 15, 1996, the PSE clarified the test of its rule by indicating that the position in a narrow-based index option may not exceed the total of: (a) the limit established under PSE Rule 7.6, plus (b) two times that limit (for hedged positions). See Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, OMS, Division, Commission, dated March 14, 1996 ("Amendment No. 3").

⁶ See Amendment No. 2, *supra* note 5.

⁷ Notional values are determined by adding the number of contracts and multiplying the total by the multiplier, expressing that number in dollar terms.

¹⁰⁰ See, comment letters 48, 63, 66, 84, 129 and 208.

¹⁰¹ See, comment letters 11, 85, 103, 121, 140, 184, 189, 191, 216, 234, and 282.

¹⁰² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1) (1988).

² 17 CFR 240.19b-4 (1995).

³ Position limits impose a ceiling on the number of option contracts which an investor or group of investors acting in concert may hold or write in each class of options on the same side of the market (i.e., aggregating long calls and short puts or long puts and short calls). Exercise limits prohibit an investor or group of investors acting in concert from exercising more than a specified number of puts or calls in a particular class within five consecutive business days.

⁴ See Securities Exchange Act Release No. 36526 (November 29, 1995), 60 FR 62517.

index option may not exceed two times the limits established under PSE Rule 7.6(a).⁸

Members, member organizations, and public customers seeking to use the proposed exemption must obtain prior Exchange approval. In addition, the exemption requires that both the option and stock positions be initiated and liquidated in an orderly manner. Specifically, a reduction of the option position must occur at or before the corresponding reduction in the stock portfolio position.

Under the proposal, exercise limits will correspond to position limits, so that investors may exercise the number of contracts set forth as the position limit, as well as those contracts exempted by the proposal, during five consecutive business days.⁹

The Exchange believes it is appropriate to expand the availability of the proposed narrow-based index option position limit exemption beyond public customers.¹⁰ According to the PSE, because customers rely, for the most part, on a limited number of proprietary traders to facilitate large-sized orders, not including such traders in the exemption effectively reduces the benefit of the exemption to customers.

The Exchange believes that its proposed narrow-based index option hedge exemption should not increase

the potential for disruption or manipulation in the markets for the stocks underlying each index. The PSE notes that the proposal incorporates several surveillance safeguards, which the Exchange will employ to monitor the use of the exemption. Specifically, the Exchange will require that member firms and their customers who seek exemptions file a form with the PSE, in lieu of granting an automatic exemption similar to that for equity options. The PSE's Options Surveillance Department will monitor trading activity in PSE-traded index options and the stocks underlying those indexes to detect potential frontrunning and manipulation abuses, as well as review to ensure that the closing of positions subject to an exemption is conducted in a fair and orderly manner. In addition, the PSE will monitor the equity position used as a hedge on a daily basis.¹¹

And lastly, the PSE notes that the provision itself contains several built-in safeguards. First, the hedge must consist of a position in at least 75% of the stocks underlying the index, so that the "basket" of stocks constituting the hedge will resemble the underlying index.¹² Second, hedged positions may not exceed two times the limit established under PSE Rule 7.6(a).¹³ This places a ceiling on the maximum size of the option position. Third, both the options and stock positions must be initiated and liquidated in an orderly manner, such that a reduction of the options position must occur at or before the corresponding reduction in the stock portfolio position. Lastly, the value of the industry index option position may not exceed the dollar value of the underlying portfolio. The purpose of this requirement is to ensure that stock transactions are not used to manipulate the market in a manner benefitting the option position. In addition, these safeguards prevent the increased positions from being used in a leveraged manner by ensuring that the options position subject to the increased hedge position limit is properly "covered" by the hedge.

For the above reasons, the Exchange believes that the proposed narrow-based index option hedge exemption should increase the depth and liquidity of

narrow-based index option markets and allow more effective hedging with underlying stock portfolios, without increasing the potential for market manipulation or disruption, consistent with the purposes of position limits. For the same reasons, the Exchange believes that exercise limits should correspond to the position limit exemption granted by this proposal.

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) thereunder.¹⁴ The Commission concludes that providing for increased position and exercise limits for narrow-based index options in circumstances where those excess positions are fully hedged with offsetting stock positions will provide greater 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.

Specifically, the PSE proposal contains safeguards that should make it difficult to use the exempted positions to disrupt or manipulate the market. First, requests for the exemption must be approved by the PSE, which should ensure that the hedges are appropriate for the position being taken and are in compliance with PSE rules. Second, the stock portfolio must consist of at least 75% of the number of component securities underlying the index, and must correspond in value to the value of the options position hedged, so that the increased positions are less likely to be used in a leveraged manner in any manipulative scheme. As noted above, the value of the hedging portfolio is equal to (a) the total market value of the net stock position, less (b) the value of (1) any offsetting calls and puts in the respective index option; (2) any offsetting positions in related stock index futures or options; and (3) any economically equivalent positions. Third, both the options and the stock positions must be initiated and liquidated in an orderly manner. Moreover, a reduction of the options position must occur at or before the corresponding reduction in the stock portfolio position, thereby helping to ensure that the stock transactions are not used to impact the market so as to benefit the options positions. Fourth, the PSE must be notified of any material

⁸ PSE Rule 7.6(a) provides that option contracts on an industry index are subject to the following position limits: 6,000 contracts if the Exchange determines, during its semi-annual review, that any single stock in the group accounted, on average, for 30% or more of the index value during the 30-day period immediately preceding the review; 9,000 contracts if the Exchange determines, at the time of its semi-annual review, that any single stock in the group accounted, on average, for 20% or more of the index value or that any five stocks in the group together accounted, on average, for more than 50% of the index value, but that no single stock in the group accounted, on average, for 30% or more of the index value during the 30-day period immediately preceding the review; or 12,000 contracts, if the Exchange determines that the conditions specified above have not occurred. See Securities Exchange Act Release No. 36537 (November 30, 1995), 60 FR 62916 (December 7, 1995) (order approving File Nos. SR-Amex-95-45 and SR-PSE-95-30) (increasing position and exercise limits for industry index options to 6,000, 9,000, or 12,000 contracts). Narrow-based index hedge exemption will allow a member organization to maintain an option position in that issue of up to 18,000 contracts on the same side of the market, provided that 12,000 of the contracts are "hedged," as provided in the proposal. See Amendment Nos. 2 and 3, *supra* note 5.

⁹ See Amendment No. 1, *supra* note 5.

¹⁰ The Exchange proposes to apply only the proposed narrow-based industry index option hedge exemption, and not the existing broad-based index option hedge exemption, to firms and proprietary traders as well as public customers. Telephone conversation between Michael Pierson, Senior Attorney, Market Regulation, PSE, and Yvonne Fraticelli, Attorney, OMS, Division, Commission, on November 14, 1995.

¹¹ See Amendment No. 1, *supra* note 5.

¹² To determine the share amount of each component required to hedge an index option position: index value x index multiplier x component's weighting = dollar amount of component. That amount divided by price = number of shares of component. Conversely, to determine how many options can be purchased based on a certain portfolio, divide the dollar amount of the basket by the index value x the index multiplier.

¹³ See Amendment No. 3, *supra* note 5.

¹⁴ 15 U.S.C. § 78f(b)(5) (1988 & Supp. V. 1993).

change in the portfolio or futures positions which materially affects the unhedged value of the qualified portfolio. Fifth, the maximum hedge exemption position is two times the existing limit.¹⁵ The "two times the limit" is not automatic and the PSE has the authority to approve a hedge limit for less than that amount.

The Commission notes that the PSE's surveillance procedures are designed to detect as well as deter manipulation and market disruptions. In particular, the PSE will monitor the equity position of a person utilizing the hedge exemption on a daily basis to ensure that each option contract is hedged by the equivalent dollar amount of component securities.¹⁶ In addition, the PSE's Options Surveillance Department will monitor trading activity in PSE-traded index options and their underlying component stocks to detect potential frontrunning and manipulation, and to ensure that the closing of positions subject to the exemption is conducted in a fair and orderly manner. Violation of any of the provisions of the industry index hedge exemption, absent reasonable justification or excuse, will result in the withdrawal of the hedge exemption and subsequent denial of an application for a hedge exemption thereunder.

The Commission believes that it is reasonable for the PSE to allow firm and proprietary traders, as well as public customers, to utilize the proposed hedge exemption. The Commission believes that extending the narrow-based index option hedge exemption to firm and proprietary traders may help to increase the depth and liquidity of the market for industry index options and may help to ensure that public customers receive the full benefit of the exemption. Moreover, the PSE's monitoring procedures, as described above, should be able to detect any abuses and ensure that the options position, whether firm, proprietary trader, or customer, is properly hedged.

Finally, the commission believes that it is reasonable for the PSE to amend the text of its broad-based index hedge exemption, and to clarify its narrow-based hedged index hedge exemption, by indicating that exercise limits under the hedge exemptions will correspond

to position limits. In this regard, the Commission notes that it has approved previously an identical amendment to the Chicago Board Options Exchange, Inc.'s ("CBOE") broad-based index Chicago Board Options Exchange, Inc.'s ("CBOE") broad-based index hedge exemption.¹⁷ In addition, the equity and index hedge exemptions of other options exchanges provide for corresponding position and exercise limits.¹⁸

The Commission finds good cause for approving Amendment Nos. 1, 2, and 3 to the proposed rule change prior to the thirtieth day after the date of publication of the notice thereof in the Federal Register. Specifically, Amendment No. 1 is designed to protect investors and the public interest by providing additional requirements and surveillance procedures which the Exchange will use in monitoring the narrow-based index option hedge exemption. In addition, Amendment No. 1 indicates that, under the PSE's broad-based and narrow-based hedge exemptions, position limits will correspond to exercise limits. As noted above, position limits correspond to exercise limits under the hedge exemption rules of the other options exchanges.¹⁹ Accordingly, the Commission does not believe that the PSE's proposal to provide corresponding position and exercise limits under its hedge exemptions raises new regulatory issues. Amendment No. 2 strengthens the Exchange's proposal providing that economically equivalent positions must be deducted when calculating the value of the hedging portfolio. Amendment No. 3 clarifies the text of the Exchange's proposal by indicating that the hedged position may not exceed two times the limit established under PSE Rule 7.6. Accordingly, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b)(2) of the Act, to approve Amendment Nos. 1, 2, and 3 to the proposal on an accelerated basis.

Solicitation of Comments

Interested persons are invited to submit written data, views and

¹⁷ See Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (order approving File No. SR-CBOE-92-09) ("CBOE" Approval Order").

¹⁸ See Securities Exchange Act Release No. 35738 (May 18, 1995), 60 FR 27573 (May 24, 1995) (order approving File Nos. SR-Amex-95-13, SR-CBOE-95-13, SR-NYSE-95-04, SR-PSE-95-05, and SR-PHLX-95-10) (order granting permanent approval to hedge exemption pilot programs) ("Hedge Exemption Order").

¹⁹ See CBOE Approval Order, *supra* note 17 and Hedge Exemption Order, *supra* note 18.

arguments concerning Amendment Nos. 1, 2, and 3. 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 at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by April 12, 1996.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁰ that the proposed rule change (SR-PSE-95-28), as amended is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland,
Deputy Secretary.

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SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster Loan Area #2838]

Idaho; Declaration of Disaster Loan Area (Amendment #1)

The above-numbered Declaration is hereby amended to establish the incident period for this disaster as beginning on February 6, 1996 and continuing through February 23, 1996.

All other information remains the same; i.e., the termination date for filing applications for physical damage is April 11, 1996, and for loans for economic injury the deadline is November 12, 1996.

(Catalog of Federal Domestic Assistance Program Nos. 59002 and 59008)

²⁰ 15 U.S.C. § 78s(b)(2) (1982).

²¹ 17 CFR 200.30-3(a)(12) (1994).

¹⁵ See Amendment No. 3, *supra* note 5.

¹⁶ See Amendment No. 1, *supra* note 5. Market participants granted a hedge exemption are also required to keep their application forms for the hedge exemption current and promptly provide the PSE with any information requested concerning the dollar value and composition of their stock portfolio or its equivalent, the current hedged and aggregate options positions, and any stock index futures positions.