

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

Jonathan G. Katz,
Secretary.

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Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 Thereto by the Pacific Stock Exchange, Inc. Relating to its Options Firm Quote Rule

August 2, 1996.

On January 16, 1996, 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 its Options Firm Quote Rule (Rule 6.86, the "Rule") in order to codify some related floor policies and also to clarify certain provisions of the Rule. Notice of the proposed rule change was published for comment and appeared in the Federal Register on March 4, 1996.³ No comment letters were received on the proposal. On May 17, 1996, the Exchange filed Amendment No. 1 to the proposal.⁴ On June 27, 1996, the PSE filed Amendment No. 2 to the proposed rule change,⁵ and on July 25, 1996, the

Exchange filed Amendment No. 3 to the proposal.⁶ This order approves the PSE proposal as amended.

I. Description of the Proposal

The Exchange is proposing to modify its Options Firm Quote Rule as follows:

Order Identification

Subsection (a) of the Rule currently provides that members and member organizations who enter orders for execution on the options floor must ascertain the account origin of such orders and provide a notation of the account origin on the order ticket. The Exchange is proposing to modify this provision to provide that such members and member organizations would be required to communicate such account information to the executing member organization. Accordingly, the member or member organization entering the order must indicate to the executing member organization whether the order is for the account of a customer, firm or market maker.

The proposal would also set forth the duty of executing floor brokers to inquire personally as to the account origin of each eligible order upon receipt thereof or prior to its execution and to note such information on the order ticket.

Finally, under the proposal, the executing member organization and the clearing member organization would bear greater responsibility with respect to the proper identification of orders that are executed on behalf of non-members of the Exchange.

Commentary .05

Proposed Commentary .05 sets forth certain types of orders that are subject to the Rule and the extent to which the Rule applies to such orders. The Rule specifically addresses the treatment of

combination orders, spread orders, straddle orders and contingency orders. With respect to combination orders involving option contracts on one side of the market, market makers in a trading crowd would only be responsible for providing an aggregate of 20 contracts; however, if a combination order is for option contracts on both sides of the market, market makers must provide a depth of 20 contracts on both sides of the market.⁷ Moreover, market makers would be required to provide a depth of 20 contracts on both sides of the market for spread and straddle orders. The proposed Commentary also enumerates the types of contingency orders that are subject to the Rule, *i.e.* "minimum" orders of 20 contracts or less, market not-held, limit not-held and delta orders that can be executed immediately, and all-or-none orders of twenty contracts or less.

The proposed Commentary also provides that in executing contingency orders pursuant to the Rule, the order ticket must be time stamped upon being taken into the trading crowd. Finally, the proposed Commentary states that such orders are entitled to 20 contracts on the market disseminated at that time.

Commentary .06

Proposed Commentary .06 provides that market makers must be afforded a reasonable opportunity to update their disseminated markets for the execution of consecutive eligible customer orders in options on the same underlying security. The Commentary further provides that such orders shall be executed on a time priority basis so that the order with the earliest time stamp will receive a guaranteed fill of 20 contracts.

Commentary .07

Proposed Commentary .07 provides that if a floor broker can immediately execute a limit order at the disseminated market price, but instead, the floor broker quotes a better price than the limit price stipulated on the order ticket, and the market then changes so that the order can no longer be executed at the disseminated market price, the floor broker shall be held liable to the customer for the execution of a minimum of 20 contracts at the original disseminated price.⁸

Commentary .08

Proposed Commentary .08 designates those market makers to whom the order book official may, pursuant to current

¹¹ 17 CFR 200.30-3(a)(12) (1995).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4

³ See Securities Exchange Act Release No. 36883 (February 23, 1996), 61 FR 8321 (March 4, 1996).

⁴ See letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to James T. McHale, Attorney, Office of Market Supervision ("OMS"), Division of Market Regulation ("Division"), Commission, dated May 16, 1996 ("Amendment No. 1"). Amendment No. 3 supersedes and replaces Amendment No. 1.

⁵ In Amendment No. 2 the Exchange revised proposed Commentary .05(a) to make clear that with respect to combination orders involving option contracts on one side of the market, market makers in a trading crowd would only be responsible for providing an aggregate of 20 contracts; however, if a combination order is for option contracts on both sides of the market, market makers must provide a depth of 20 contracts on both sides of the market. Additionally, the Exchange revised proposed Commentary .07 to clarify that a floor broker, who has the opportunity to execute a limit order at the disseminated market price, but instead quotes a better price than the limit price stipulated on the order ticket and the market then changes so that the order can no longer be executed at the original disseminated price, will be held liable for the execution of a minimum of 20 contracts at the original disseminated price. See letter from Michael

D. Pierson, Senior Attorney, Regulatory Policy, PSE, to James T. McHale, Attorney, Office of Market Supervision ("OMS"), Division of Market Regulation ("Division"), Commission, dated June 26, 1996 ("Amendment No. 2").

⁶ In Amendment No. 3 the Exchange clarified a potential ambiguity in proposed Commentary .05(c) to Rule 6.86 by deleting a sentence which specified certain types of contingency orders to which Rule 6.86 did not apply. In addition, Amendment No. 3 deletes a sentence in proposed Commentary .05(c) which stated that the list of types of contingency orders to which the Rule applies would not be considered exhaustive. Finally, in Amendment No. 3 the PSE further clarifies proposed Commentary .07 to provide that the executing floor broker will be held liable to *his customer* for a minimum of 20 contracts at the original disseminated price, if the floor broker had the opportunity to execute the customer's limit order, but instead made a failed attempt to improve the execution. See letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to James T. McHale, Attorney, OMS, Division, Commission, dated May 16, 1996 ("Amendment No. 3").

⁷ See Amendment No. 2, *supra* note 5.

⁸ See Amendment Nos. 2 and 3, *supra*, notes 5 and 6, respectively.

Subsection (d), allocate the balance of contracts necessary to provide an execution of 20 contracts when the response of the members present at the trading post is insufficient to provide a depth of 20 contracts. Specifically, such allocations may be made to market makers who: (1) are present at the trading post at the time of a call for a market; and either (2) hold an appointment in the option classes at the trading post or (3) regularly effect transactions in person for their trading accounts at that trading post.

In addition, this proposed Commentary provides that market makers who have logged on to the Exchange's Automatic Execution system ("Auto-Ex"),⁹ but who are not present in the trading crowd will not be eligible for an allocation by the order book official pursuant to current Subsection (d).

II. Discussion

The Commission finds that the proposed rule change relating to the PSE's Options Firm Quote Rule 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)¹⁰ in that it is designed to facilitate transactions in securities, promote just and equitable principles of trade, and protect investors and the public interest. Specifically, with respect to "order identification," the Commission believes that the rule change further clarifies the account origin responsibilities of the parties involved in a trade which is subject to the Rule. The rule change requires, among other things, that the executing floor broker verify whether the order is being executed for the account of a customer, firm or market maker. This clarification provides objective criteria against which the executing floor broker's actions can be measured and, thus, should make enforcement of the Rule more effective for the Exchange.

Moreover, the Commission believes that interpreting the Options Firm Quote Rule as set forth in new Commentary .05 is consistent with the Act and the intent of the Rule.¹¹ The

Rule currently provides that all non-broker/dealer customer orders are entitled to execution at the bid or offer which is displayed as the disseminated market quote up to a depth of 20 contracts. With regard to combination orders, the Exchange has proposed clarifying that market makers are responsible for providing an aggregate of 20 contracts for combination orders on one side of the market, but 20 contracts on both sides of the market for combination orders on two sides of the market. The Commission believes this is reasonable since interpreting the Rule to require market makers to provide 20 contracts for combination orders involving options on the same side of the market would essentially create a "40-up" requirement, and potentially place undue burdens and capital risks on the PSE's options market makers.

With respect to new Commentary .06, the Commission believes that it is appropriate and consistent with the Act¹² for market makers to have a reasonable opportunity to update their market quotes for the execution of consecutive eligible customer orders in options on the same underlying security. Moreover, to provide that such orders shall be executed on a time priority basis so that the order with the earliest time stamp will receive a guaranteed fill of 20 contracts, is a fair interpretation of the Rule.

Commentary .07 provides that if a floor broker can immediately execute a limit order at the disseminated market price, but instead the floor broker quotes a better price than the limit price stipulated on the order ticket, and the market then changes so that the order can no longer be executed at the disseminated market price, the floor broker shall be held liable to the customer for the execution of a minimum of 20 contracts at the original disseminated price. The Commission believes that this should be an effective measure to protect investors by ensuring that a customer's executable limit order is filled at the limit price even if the floor broker makes a failed attempt at improving the execution. Finally, Commentary .08 provides an appropriate method to designate which

market makers in the trading crowd are eligible to be allocated option contracts.

The Commission finds good cause for approving Amendment Nos. 2 and 3 to the proposal prior to the thirtieth day after the date of publication of the notice of filing thereof in the Federal Register. Specifically, in filing Amendment No. 2, the Exchange recognizes that some combination orders involve both sides of the market (e.g. "strangles"¹³). Amendment No. 2 changes Commentary .05(a) to clarify that while a market maker's responsibility with respect to combination orders on one side of the market is to provide an aggregate of 20 contracts, the market maker must provide a depth of 20 contracts on both sides of the market for combination orders that involve an order for option contracts on both sides of the market. Amendment No. 2 also strengthens Commentary .07 by clarifying that a floor broker, who has the opportunity to execute a limit order at the disseminated market price, but instead quotes a better price than the limit price stipulated on the order ticket and the market then changes so that the order can no longer be executed at the original disseminated price, will be held liable for the execution of a minimum of 20 contracts at the original disseminated price.

Amendment No. 3 eliminates language in Commentary .05(c) that would have prohibited application of the Rule to certain types of contingency orders. The Exchange has determined that it is more appropriate to define those types of orders to which the Rule applies, rather than defining those orders to which the Rule does not apply. Additionally, in Amendment No. 3 the PSE has eliminated a sentence in Commentary .05(c) which stated that the list of types of contingency orders to which the Rule applies would not be considered exhaustive. The Commission believes that these changes strengthen the proposal by setting forth a clear and finite set of contingency order types to which the Rule applies. Finally, Amendment No. 3 further amends proposed Commentary .07 to provide that the executing floor broker will be held liable to his customer for a minimum of 20 contracts at the original disseminated price, if the floor broker had the opportunity to execute the customer's limit order, but instead made a failed attempt to improve the execution. The Commission believes

⁹ The Auto-Ex system permits eligible market or marketable limit orders sent from member firms to be executed automatically at the displayed bid or offering price. Participating market makers are designated as the contra side to each Auto-Ex order and are assigned by Auto-Ex on a rotating basis, with the first market maker selected at random from the list of signed-on market makers. See Securities Exchange Act Release No. 34946 (November 7, 1994), 59 FR 59265 (November 16, 1996).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See Securities Exchange Act Release No. 28021 (May 16, 1990) 55 FR 21131 (May 22, 1990) (order

approving PSE's original proposal requiring ten-up markets on a one-year pilot basis). The Exchange subsequently increased its minimum size guarantee for non-broker/dealer customer orders from 10 to 20 contracts. See Securities Exchange Act Release No. 34891 (October 25, 1994) 59 FR 54653 (November 1, 1994).

¹² Cf. 17 CFR 11Ac1-1(c). This firm quote rule, applicable to certain equity securities, generally allows market makers a reasonable period of time to update their quotations following an execution. See Securities Exchange Act Release No. 37502 (July 30, 1996).

¹³ A strangle is a combination order involving the same underlying stock in which the put and the call have the same expiration date but different exercise prices.

that this portion of Amendment No. 3 clarifies a potential ambiguity in the interpretation of new Commentary .07, and, therefore, is not a substantive change to the proposal.

Based on the above, the Commission finds good cause for approving Amendment Nos. 2 and 3 to the proposed rule change on an accelerated basis and believes that the proposal, as amended, is consistent with Sections 6(b)(5) and 19(b)(2) of the Act.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 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 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 the File No. SR-PSE-96-01 and should be submitted by August 30, 1996.

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (SR-PSE-96-01) is approved.

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

Jonathan G. Katz,

Secretary.

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[Release No. 34-37515; File No. SR-PTC-96-03]

Self-Regulatory Organizations; Participants Trust Company; Order Granting Accelerated Approval of a Proposed Rule Change Relating to the Intraday Return of Participants' Prefunding Payments

August 2, 1996.

On June 3, 1996, Participants Trust Company ("PTC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-PTC-96-03) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ to permit the intraday return of prefunding payments to participants. Notice of the proposal was published in the Federal Register on July 7, 1996.² No comment letters were received. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

I. Description

The rule change amends Article V, Rule 2, Section 5 of PTC's rules and establishes initial procedures to enable PTC to make intraday returns of participants' prefunding payments. Only prefunding payments which are received early in the day and which are no longer needed to support transaction processing at PTC will be eligible for intraday return. Previously, prefunding payments were applied to that day's settlement or withdrawn on the next business day or thereafter.³ The rule change is to allow PTC to make these funds available to participants on the same day they are deposited with PTC in order that the depositing participants may use the funds to reduce daylight overdraft exposures or to ease liquidity pressures in other financial markets.

PTC will implement the intraday return of prefunding payments to participants with initial procedures to be incorporated into PTC's Participant's Operating Guide.⁴ The initial

¹ 15 U.S.C. 78s(b)(1) (1988).

² Securities Exchange Act Release No. 37402 (July 2, 1996), 61 FR 36601.

³ "Optional deposits," which include prefunding payments, are defined in PTC's rules as "a participant's voluntary deposits to the participants fund with respect to any master account pursuant to Section 3 of Rule 2 of Article V." Article V, Rule 2, Section 3 states that participants may elect or be required to make optional deposits to the participants fund to (i) provide supplemental processing collateral to increase a participant's net free equity ("NFE"), (ii) prefund a debit balance in a participant's account, or (iii) permit free retransfers of securities from a transfer account.

⁴ Upon implementation of the program, PTC plans to evaluate the initial procedures on a quarterly basis and will make changes to such procedures as necessary based upon PTC's

procedures will provide that (i) all prefunding return transactions will be subject to PTC's standard credit controls (*i.e.*, a prefunding payment may be returned only if a participant will be within its NFE and net debit monitoring level requirements after such prefunding payment is returned); (ii) only prefunding payments received by PTC between 8:30 a.m. and 11:00 a.m. E.S.T. will be eligible for intraday return; (iii) during the initial stage of the pilot program, only eighty percent of qualifying prefunding payments will be eligible for intraday return;⁵ (iv) participants will be allowed only one intraday return per day; (v) the minimum amount eligible for intraday return is \$10 million; and (vi) all intraday returns are expected to be made by PTC between 11:00 a.m. and 12:00 p.m. E.S.T.

II. Discussion

Section 17A(b)(3)(F)⁶ of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. For the reasons set forth below, the Commission believes that PTC's proposed rule change is consistent with PTC's obligations under the Act.

The return to participants of prefunding payments that are no longer needed to support transaction processing at PTC should enhance participants' liquidity during the day. Although the amounts returned to participants under the program could possibly be used to fund debits at PTC later in the day, the benefits derived from providing participants with increased intraday liquidity appear to outweigh PTC's interests in retaining the prefunding payments after situations necessitating such deposits have been remedied. PTC should be able to provide for the intraday return of prefunding payments while still assuring the safeguarding of securities and funds in its custody or control because PTC will not return any prefunding payments unless the requesting participant is in compliance with NFE and net debit monitoring level controls at the time the request is made.

PTC has requested that the Commission find good cause for

experience with the program. PTC will be required to file with the Commission a proposed rule change prior to any change or modification of the initial procedures.

⁵ This limitation is to minimize the risk that subsequent transactions will fail PTC's credit controls.

⁶ 15 U.S.C. 78q-1(b)(3)(F) (1988).

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ CFR 200.30-3(a)(12).