

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 Amex. All submissions should refer to File No. SR-Amex-96-50 and should be submitted by February 6, 1997.

For the Commission by the Division of Market Regulation, pursuant to delegated authority:⁹

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-38143; File No. SR-Amex-96-35]

**Self-Regulatory Organizations;
American Stock Exchange, Inc.; Order
Approving Proposed Rule Change and
Notice of Filing and Order Granting
Accelerated Approval of Amendment
Nos. 1 and 2 Relating to the Trading of
Options on the Tobacco IndexSM**

January 8, 1997.

I. Introduction

On October 1, 1996, the American Stock Exchange, Inc. ("Amex" or "Exchange") filed with 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 relating to the trading of options on The Tobacco IndexSM. The proposal was published for comment in the Federal Register on October 24, 1996.³ The Exchange filed an amendment ("Amendment No. 1")⁴ to its proposal

on November 8, 1996. The Exchange filed a second amendment ("Amendment No. 2")⁵ to its proposal on December 6, 1996. No comments were received on the proposed rule change. This order approves the Exchange's proposal as amended.

II. Description of the Proposal

A. General

The Amex proposes to trade options on The Tobacco IndexSM ("Index"), a new index developed by the Amex composed of tobacco company stocks (or American Depositary Receipts ("ADRs") thereon) that are traded on the Amex and the New York Stock Exchange ("NYSE"). In addition, the Amex proposes to amend Rule 901C, Commentary .01, to reflect that 90% of the Index's numerical value will be accounted for by stocks that meet the current criteria and guidelines set forth in Rule 915.

B. Composition of the Index

The Amex proposes to trade standardized options on the Index, developed by the Amex, representing a portfolio of large, actively traded tobacco company stocks.⁶ The Index will comprise nine tobacco industry stocks. The components of the Index will be American Brands, Inc.; B.A.T. Industries P.L.C.; Dimon, Inc.; Empresas La Modernas (ADR); Loews Corp.; Philip Morris Companies, Inc.; RJR Nabisco Holdings Corporation, Inc.; UST, Inc.; and Universal Corporation.⁷ The Index was initialized at a level of 250 at the close of trading on August 16, 1996. As of January 2, 1997, the Index had a value of approximately 289. The Exchange will use an "equal-dollar weighted" method to calculate the value of the Index.⁸ The market capitalizations of the individual stocks in the Index as of the close of trading on August 23, 1996 ranged from a high

of \$73 billion to a low of \$762 million, with the median and average being \$6.9 billion and \$14 billion respectively. As of the close of trading on August 23, 1996, no one stock accounted for more than 11.50% of the Index's total weight, and the percentage weighting of the five largest issues in the Index accounted for 56.92% of the Index's value.

C. Eligibility Standards for the Inclusion of Component Stocks in the Index

The Index conforms with Exchange Rule 901C, which specifies criteria for inclusion of stocks in a narrow-based index on which standardized options will be traded on the Exchange. In addition, the Index conforms to most of the criteria set forth in Rule 901C, Commentary .02 (which provides for the commencement of trading of options on an index thirty days after the date of filing)⁹ except that there are only nine component securities,¹⁰ and that four (or 44%) of the components have a minimum monthly volume during the preceding six months of less than 1,000,000 shares, with one component having traded less than 500,000 shares in at least one of the last six months.¹¹

All of the component securities meet the following eligibility standards: (1) all component securities are traded on the Amex, NYSE, or are traded through the facilities of the National Association of Securities Dealers Automated

⁹ Under Amex Rule 901C, Commentary .02, the Amex may list options on a stock industry index pursuant to Section 19(b)(3)(A) under the Act, provided that the index satisfies certain criteria. See securities Exchange Act Release No. 34157 (June 3, 1994), 59 FR 30062 (approving substantially identical proposed rule amendments from the Amex, the NYSE, the Philadelphia Stock Exchange, Inc. ("Phlx"); the Chicago Board Options Exchange, Inc. ("CBOE"); and the Pacific Stock Exchange, Inc. ("PSE") relating to narrow-based index options listing standards).

¹⁰ *Id.* The generic standards require that upon the initial listing of narrow-based index options, the underlying index must include at least ten stocks. Thereafter, the index must contain at least nine component stocks at all times.

¹¹ *Id.* The generic initial listing standards require that component stocks comprising the top 90 percent of the index, by weight, must have a monthly trading volume of at least 1,000,000 shares per month over the six months preceding the filing of the index with the Commission; thereafter, the component stocks must maintain monthly trading volume of at least 500,000 shares per month. The trading volume for the component stocks constituting the bottom 10 percent of the index, by weight, must have been at least 500,000 shares over the same initial period; thereafter, they must meet an average monthly trading volume of at least 400,000 shares per month.

B.A.T. Industries PLC is the one component whose minimum monthly trading volume was less than 400,000 shares. In February 1996, B.A.T. traded only 395,800 shares. During the most recent six month period, however, B.A.T.'s trading volume has increased, with a high of 6.74 million shares in August 1996, and a low of 866,500 shares in October 1996. Amendment No. 1, *supra* note 4.

⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 37839 (October 17, 1996), 61 FR 55176.

⁴ Amendment No. 1 provides information and representations with respect to the proposed rule change. Letter from Claire P. McGrath, Managing Director and Special Counsel, Derivative Securities, Amex, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated November 7, 1996.

⁵ Amendment No. 2 provides further information and representations with respect to the proposed rule change. Letter from Claire P. McGrath, Managing Director and Special Counsel, Derivative Securities, Amex, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated December 5, 1996.

⁶ A list of securities comprising the Index, as well as listed shares outstanding and prices as of August 23, 1996, was submitted by the Exchange as Exhibit B, and is available at the principal office of the Amex and at the Commission.

⁷ American brands, Inc. Plans to spin off remaining tobacco related business by the middle of next year. As a result of the spin-off the Amex anticipates that it will replace American Brands, Inc. in the Index with a company in the tobacco industry. Amendment No. 1, *supra* note 4.

⁸ See *infra* Section II.D entitled "Calculation of the Index" for a description of this calculation method.

Quotation System ("Nasdaq") and are reported national Market System securities;¹² (2) component stocks comprising the top 90 percent of the Index by weight have a market capitalization¹³ of at least \$75 million, and those component stocks constituting the bottom 10 percent of the Index by weight have a market capitalization of at least \$50 million; (3) no single component will represent more than 25% of the weight of the Index and the five highest weighted components will represent no more than 60% of the Index; (4) at least 90% of the Index's numerical value and at least 80% of the total number of component securities is accounted for by stocks that meet the current criteria and guidelines set forth in Rule 915;¹⁴ and (5) foreign country securities or ADRs thereon that are not subject to comprehensive surveillance agreements do not in the aggregate represent more than 20% of the weight of the Index.

D. Calculation of the Index

The Index is calculated using an "equal-dollar weighting" methodology. The following is a description of how equal-dollar weighting calculation method works. As of the market close on August 16, 1996, a portfolio of tobacco company stocks was established representing an investment of approximately \$100,000 in the stock (rounded to the nearest whole share) of each of the companies in the Index. The value of the Index equals the current market value (*i.e.*, based on U.S. primary market prices) of the sum of the assigned number of shares of each of the stocks in the Index portfolio divided by the Index divisor. The Index divisor was initially determined to yield the benchmark value of 250.00 at the close of trading on August 16, 1996. Quarterly thereafter, following the close of trading on the third Friday of February, May, August and November, the Index portfolio will be adjusted by changing

the number of whole shares of each component stock so that each company is again represented in "equal" dollar amounts. If necessary, a divisor adjustment is made at the rebalancing to ensure continuity of the Index's value. The newly adjusted portfolio becomes the basis for the Index's value on the first trading day following the quarterly adjustment.

As noted above, the number of shares of each component stock in the Index portfolio remain fixed between quarterly reviews, except in the event of certain types of corporate actions, such as the payment of a dividend (other than an ordinary cash dividend), stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or similar event with respect to the component stocks. In a merger or consolidation of an issuer of a component stock, if the stock remains in the Index, the number of shares of that security in the portfolio may be adjusted, if necessary, to the nearest whole share, to maintain the component's relative weight in the Index at the level immediately prior to the corporate action. In the event of a stock addition or replacement, the average dollar value of the remaining Index components will be calculated and that amount invested in the stock of the new component to the nearest whole share. In all cases, the divisor will be adjusted, if necessary, to ensure Index continuity.

Similar to other stock index values published by the Exchange, the value of the Index will be calculated continuously and disseminated every 15 seconds over the Consolidated Tape Association's Network B.

E. Maintenance of the Index

The Exchange will maintain the Index so that upon quarterly rebalancing (1) all component securities are traded on the Amex, NYSE, or traded through the facilities of the Nasdaq and are reported National Market System securities;¹⁵ (2) the total number of component securities will not increase or decrease by more than 33-1/3% from the number of components in the Index at the time of its initial listing, and in no event will the Index have less than nine components; (3) component stocks constituting the top 90% of the Index by weight will have a minimum market capitalization of \$75 million and the component stocks constituting the bottom 10% of the Index by weight will have a minimum market capitalization of \$50 million; (4) stocks constituting

85% of the Index have a monthly trading volume of at least 500,000 shares for each of the last six months and those stocks constituting 15% of the Index have a monthly trading volume of at least 300,000 shares for each of the last six months;¹⁶ (5) no single component will represent more than 25% of the weight of the Index and the five highest weighted components will represent no more than 60% of the Index at each quarterly rebalancing; (6) at least 90% of the index's numerical index value and at least 80% of the total number of component securities individually will meet the then current criteria for standardized option trading set forth in Exchange Rule 915; and (7) foreign country securities or ADRs thereon that are not subject to comprehensive surveillance agreements do not in the aggregate represent more than 20% of the weight of the Index.¹⁷ If the Index fails to satisfy any of the maintenance criteria set forth above, the Exchange shall, in accordance with Rule 916C, take actions which include, but are not limited to, prohibiting the opening for trading of any additional option series,¹⁸ unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of options on the Index has been approved by the Commission pursuant to Section 19(b)(2) of the Act.

F. Expiration and Settlement

The exercise settlement value for all of the Index's expiring options will be calculated based upon the primary exchange regular way opening sale prices for the component stocks on the last trading day prior to expiration. In the case of National Market securities traded through Nasdaq, the first reported regular way sale price will be used. If any component stock does not open for trading on its primary market on the last trading day before expiration, then the prior day's last sale price will be used in the calculation.¹⁹

¹⁶ Amendment No. 2, *supra* note 5.

¹⁷ Amendment No. 1, *supra* note 4.

¹⁸ Amendment No. 2, *supra* note 5. See also *infra* note 28.

¹⁹ The Commission notes that pursuant to Article XVII, Section 4 of the Options Clearing Corporation's ("OCC") by-laws, OCC is empowered to fix an exercise settlement amount in the event it determines a current index value is unreported or otherwise unavailable. Further, OCC has the authority to fix an exercise settlement amount whenever the primary market for the securities representing a substantial part of the value of an underlying index is not open for trading at the time when the current index value (*i.e.*, the value used for exercise settlement purposes) ordinarily would be determined. See Securities Exchange Act Release

¹² Securities Exchange Act Release No. 34157, *supra* note 9. The generic initial listing and maintenance listing standards require that all component stocks be deemed "reported securities" as that term is defined in Rule 11Aa3-1 under the Act. Accordingly, a proposed narrow-based index currently can only comprise exchange-listed and Nasdaq National Market System securities.

¹³ In the case of ADRs, this represents market capitalization as measured by total world-wide shares outstanding.

¹⁴ Amex staff have represented that all underlying stocks are options eligible, and all but Dimon, Inc. and UST, Inc. currently have options traded on them. Telephone conversation between Claire P. McGrath, Managing Director and Special Counsel, Derivative Securities, Amex, and Janet W. Russell-Hunter, Special Counsel, Office of Market Supervision, Division of Market Regulation, Commission, October 16, 1996.

¹⁵ Amendment No. 1, *supra* note 4.

G. Contract Specifications

The proposed options on the Index will be European-style (i.e., exercises permitted at expiration only), and cash-settled. Standard option trading hours (9:30 a.m. to 4:10 p.m. New York time) will apply. The options on the Index will expire on the Saturday following the third Friday of the Expiration month ("Expiration Friday"). The last trading day in an expiring option series will normally be the second to last business day preceding the Saturday following the third Friday of the expiration month (normally a Thursday). Trading in expiring options will cease at the close of trading on the last trading day.

The Exchange plans to list options series with expirations in the three near-term calendar months and in the two additional calendar months in the February cycle. In addition, longer-term option series having up to thirty-six months to expiration may be traded. In lieu of such long-term options on a full value Index level, the Exchange may instead list long-term, reduced value put and call options based on one-tenth ($\frac{1}{10}$ th) the Index's full value. In either event, the interval between expiration months for either a full value or reduced value long-term option will not be less than six months.

H. Exchange Rules Applicable to Stock Index Options

Because the Index is deemed to be a Stock Index Option under Rule 901C(a) and a Stock Index Industry Group under Rule 900C(b)(1), Amex Rules 900C through 980C, which are applicable to the trading of narrow-based index options, will apply to the trading of option contracts based on the Index. These rules cover issues such as surveillance, exercise prices,²⁰ position and exercise limits,²¹ margin requirements,²² and trading halts.²³ Surveillance procedures currently used to monitor trading in each of the Exchange's other index options will also be used to monitor trading in options on the Index. Pursuant to Rule 903C(b) regarding exercise prices, the Exchange proposes to list near-the-money option series on the Index at $2\frac{1}{2}$ point strike (exercise) price intervals when the value of the Index is below 200 points. In addition, the Exchange expects that the review required by Rule 904C(c) will result in a position limit of 9,000

contracts with respect to options on this Index.²⁴

The trading of any long-term options would be subject to the same rules which govern the trading of all the Exchange's index options, including sales practice rules, margin requirements and floor trading procedures, and all options will have European-style exercise. Position limits on reduced value long-term Index options will be equivalent to the position limits for regular (full value) Index options and would be aggregated with such options. For example, if the position limit for the full value options is 9,000 contracts on the same side of the market, then the position limit for the reduced value options will be 90,000 contracts on the same side of the market.

III. 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 the requirements of Section 6(b)(5).²⁵ Specifically, the Commission finds that the trading of Index options will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with an additional means to hedge exposure to market risk associated with stocks in the tobacco industry.²⁶ The trading of options in the Index, however, raises several issues relating to index design, customer protection, surveillance, and market impact. The Commission believes, for

the reasons discussed below, that the Amex has adequately addressed these issues.

A. Index Design and Structure

The Commission believes it is appropriate and consistent with the Act for the Exchange to designate the Index as a narrow-based index for the purposes of options trading. The Index comprises a limited number (nine) of stocks intended to track the tobacco sector of the stock market. Accordingly, the Commission believes it is appropriate for the Amex to apply its rules governing narrow-based index options to trading in the Index options.²⁷ The Commission believes that the large market capitalizations, liquid markets, and relative weightings of the Index's component stocks significantly minimize the potential for manipulation of the Index.

First, the stocks that comprise the Index are actively traded, with a median and average of the minimum monthly trading volume for the six month period ending August 23, 1996 of 3.1 million shares and 7.6 million shares respectively. Second, the market capitalizations of the stocks in the Index are very large, ranging from a high of \$73 billion to a low of \$762 million, with the median and average being \$6.9 billion and \$14 billion respectively. Third, because the index is equal-dollar weighted, no one particular stock dominates the Index. Specifically, as of August 23, 1996, no one stock accounted for more than 11.50% of the Index's total weight, and the percentage weighting of the five highest weighted stocks in the Index accounted for under 57% of the Index's value.

Fourth, the Index will be maintained so that in addition to the other maintenance criteria discussed above, at each quarterly review and rebalancing, at least 90% of the Index's numerical index value and at least 80% of the total number of component securities is accounted for by stocks that meet the current criteria and guidelines set forth in Rule 915. The Commission believes that this requirement will ensure that the Index will be almost entirely made up of stocks with large public floats that are actively traded, thus reducing the likelihood that the Index could be easily manipulated by abusive trading in smaller stocks contained in the Index. All component stocks in the Index are eligible for standardized options trading, and all of the component stocks, other than Dimon, Inc. and UST, Inc., currently have standardized options trading on them.

²⁴ Amex Rule 904C(c) provides that the position limit for an industry index option will be 9,000 contracts if the Amex determines at the commencement of trading of the options that any single stock in the underlying stock index industry group accounted, on average, for 20% or more of the numerical index value or that any five stocks in the group together accounted, on average, for more than 50% of the numerical 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.

²⁵ 15 U.S.C. 78f(b)(5).

²⁶ Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option proposal upon a finding that the introduction of any such new derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument that served no hedging or other economic function, because any benefits that might be derived by market participants would likely be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed options on the Index will provide investors with a hedging vehicle that should reflect the overall movement of the stocks representing companies in the tobacco industry in the U.S. stock markets.

²⁷ See *supra* Section II.H.

No. 37315 (June 17, 1996), 61 FR 42671 (order approving SR-OCC-95-19).

²⁰ See Amex Rule 903C(b).

²¹ See Amex Rule 904C and 905C.

²² See Amex Rule 462(d)(2)(D)(iv).

²³ See Amex Rule 918C.

Fifth, if the Index fails to satisfy any of the maintenance criteria set forth above, the Exchange shall, in accordance with Rule 916C, take actions which include, but are not limited to, prohibiting the opening for trading of any additional option series,²⁸ unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of options on the Index has been approved by the Commission pursuant to Section 19(b)(2) of the Act.

Sixth, the Amex will be required to ensure that each component of the Index is subject to last sale reporting requirements in the U.S. pursuant to Rule 11Aa3-1 of the Act. This will further reduce the potential for manipulation in the value of the Index. Finally, the Commission believes that the existing mechanisms to monitor trading activity in the component stocks of the Index, or options on those stocks, will help as well as detect any illegal activity.

B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as Index options, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) the special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index options will be subject to the same regulatory regime as other standardized index options currently traded on the Amex, the Commission believes that adequate standards are in place to ensure the protection of investors in Index options.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities

markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less susceptible to manipulation.²⁹ In this regard, the Amex, NYSE, and National Association of Securities Dealers, Inc., on whose markets the component securities of the Index trade, are all members of the Intermarket Surveillance Group ("ISG"), which provide for exchange of all necessary surveillance information.³⁰ Options on the individual component securities also trade on markets which are ISG members.

D. Market Impact

The Commission believes that the listing and trading of Index options on the Amex will not adversely impact the underlying securities markets.³¹ First, as described above, due to the "equal dollar-weighting" method, no one stock or group of stocks dominates the Index. The quarterly rebalancing of the Index also will continue to ensure that domination by one or more stocks will not occur. Second, the component stocks generally will be actively traded, highly capitalized stocks. Third, all stocks comprising the Index are options eligible, and the maintenance standards ensure that at least 90% of the Index's numerical index value will continue to be options eligible. Fourth, the 9,000 contract position and exercise limits will serve to minimize potential manipulation and market impact concerns. Fifth, existing Amex stock

index option rules and surveillance procedures will apply to the Index options. Sixth, the risk to investors of contra-party non-performance will be minimized because the Index options will be issued and guaranteed by the Options Clearing Corporation, just like any other standardized option traded in the United States.

Finally, the Commission believes that settling expiring Index options based on the primary exchange regular way opening sale prices of component securities is reasonable and consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than closing prices may help reduce adverse effects on markets for stocks underlying options on the Index.³²

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 of filing thereof in the Federal Register. Specifically, the amendments clarify and strengthen the proposal by adding maintenance criteria and providing other information about the Index. Furthermore, the Amex's original proposal was published in the Federal Register for the full 21 day comment period without any comments being received by the Commission. The Commission notes that, with the exception of the initial number of components underlying the Index and the trading volume of certain components, the proposal, as amended, satisfies the Exchange's generic narrow-based index option listing standards contained in Amex Rule 901C, Commentary .02. As discussed above, the Commission believes that accelerating approval of Amendment Nos. 1 and 2 will allow the Exchange to begin listing options on the Index without further delay in order to provide an additional exchange-traded hedging vehicle for investors with risk exposure to securities in the various technology industries.

Based on the above, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act, and that good cause exists to approve Amendment Nos. 1 and 2 to the Amex's 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 to the proposed rule change. Persons making written submissions

²⁸ Other action that might be taken in consultation with Commission staff for failure to meet the maintenance standards would include the prohibition of opening transactions. See *e.g.* AMEX Rule 916C.

²⁹ See Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849.

³⁰ The ISG was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. See Intermarket Surveillance Group Agreement, dated July 14, 1983, amended January 29, 1990. The members of the ISG are: Amex; Boston Stock Exchange, Inc.; CBOE; Chicago Stock Exchange, Inc.; National Association of Securities Dealers, Inc.; NYSE; PSE; and Phlx. The major stock index futures exchanges, including the Chicago Mercantile Exchange and the Chicago Board of Trade, joined the ISG as affiliate members in 1990.

³¹ In addition, the Amex has represented that the Amex and the Options Price Reporting Authority ("OPRA") have the necessary systems capacity to support this new series of index options that would result from the introduction of Index options. See Letter from Edward Cook, Jr., Managing Director, Information Technology, Amex, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated October 30, 1996; Letter from Charles H. Faurot, Managing Director, Market Data Services, Amex, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated November 4, 1996; Letter from Joseph P. Corrigan, Executive Director, OPRA, to Ivette Lopez, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated November 4, 1996.

³² Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376.

should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., 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 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 Amex. All submissions should refer to the File No. SR-Amex-96-35 and should be submitted by February 6, 1997.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,³³ that the proposed rule change (SR-Amex-96-35), as amended, is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.³⁴

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-38156; File No. SR-NASD-96-43]

**Self-Regulatory Organizations;
National Association of Securities
Dealers, Inc.; Order Granting Partial
Approval and Notice of Filing and
Order Granting Accelerated Approval
of Amendment No. 1 to Proposed Rule
Change Relating to Implementation of
the Commission's Order Handling
Rules**

January 10, 1997.

On November 18, 1996, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹, and Rule 19b-4 thereunder.² On January 9, 1997, the NASD submitted a letter amending the proposed rule change.³

The proposed rule change adopts a new rule, and amends existing NASD rules and The Nasdaq Stock Market's ("Nasdaq") Small Order Execution System ("SOES") and SelectNet Service to enable the NASD to implement on a timely basis the Commission's new limit order display rule, Rule 11Ac1-4 under the Act⁴ ("Display Rule") and amendments to Rule 11Ac1-1 under the Act⁵ ("Quote Rule").

Notice of the proposed rule change, together with the substance of the proposal as initially filed, was provided by issuance of a Commission release (Securities Exchange Act Release No. 38008, Dec. 2, 1996) and by publication in the Federal Register (61 FR 64550, Dec. 5, 1996). The Commission received over 350 comment letters on the proposal.

I. Introduction and Background

A. The Commission's Order Handling Rules

On August 28, 1996, the Commission adopted the Display Rule, which requires the display of customer limit orders priced better than a market maker or specialist's quote, and adopted amendments to the Quote Rule to enhance the quality of published quotations for securities, and competition and pricing efficiency in U.S. securities markets.⁶ These rules (collectively, "Order Handling Rules") were designed to address growing concerns about the handling of customer orders for securities.

Specifically, the Display Rule⁷ requires the display of a customer limit order priced better than a specialist's or over-the-counter ("OTC") market maker's quote or that adds to the size associated with such quote if that quote

for reduction of the market maker minimum quotation size in the fifty Nasdaq securities subject to the first phase-in of the Order Handling Rules; (2) state that a market maker's obligation to maintain its displayed quotation size at or above the applicable minimum quotation size does not apply when the market maker's quote size has been decremented by the execution of SOES orders, until that quotation size is decremented to zero; (3) make the decrementing provision optional for market makers whose quotation in a particular security is equal to or greater than the SOES tier size for that security; and (4) permit market makers to enter riskless principal orders, in addition to agency orders, into the Small Order Execution System.

⁴ 17 CFR 240.11Ac1-4.

⁵ 17 CFR 240.11Ac1-1.

⁶ See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Adopting Release"). See also Securities Exchange Act Release Nos. 38110 (January 2, 1997), 62 FR 1279 (January 9, 1997) (order revising the effective date of the Order Execution Rules to January 13, 1997); and 38139 (January 8, 1997) (order revising the effective date of the Order Execution Rules until January 20, 1997).

⁷ 17 CFR 240.11Ac1-4.

is at the national best bid or offer ("NBBO"). An OTC market maker who receives a customer limit order meeting these parameters must immediately: (1) change its quote and the size associated with its quote to reflect the limit order; (2) execute the limit order; (3) deliver the limit order to an exchange-or association-sponsored system that complies with the requirements of the rule; (4) send the limit order to another market maker or specialist who complies with the requirements of the rule; or (5) deliver a limit order to an electronic communications network ("ECN") that meets certain requirements regarding the display of limit orders, as an alternative to representing the limit order in its quote.⁸

One amendment to the Quote Rule⁹ requires an OTC market maker to make publicly available any superior prices that a market maker privately quotes through ECNs ("ECN Amendment"). A market maker may comply with this amendment by changing its quote to display any such superior prices privately quoted. Alternatively, a market maker can deliver better priced orders to an ECN without changing its public quote if that ECN: (i) ensures that the best prices market makers and specialists have entered therein are communicated to the public quotation system; and (ii) provides brokers and dealers equivalent access to orders entered by market makers and specialists into the ECN, so brokers and dealers that do not subscribe to the ECN can trade with those orders ("ECN Display Alternative").

The ECN amendment becomes effective on January 20, 1997 for exchange traded securities and 50 of the 1000 most actively traded OTC securities. These 50 securities have been identified by Nasdaq.¹⁰ The phase-in date for the next 100 securities is scheduled for February 7, 1997. On February 28, 1997, the additional 850 of the 1000 most actively traded securities will be phased in. Finally, on March 28, 1997, the ECN amendment will apply to all remaining OTC securities.

The Limit Order Display Rule also becomes effective on January 20, 1997 for all exchange traded securities and 50 OTC securities identified by Nasdaq. Other Nasdaq securities will become

⁸ The Display Rule does not apply to limit orders placed by customers requesting that they not be displayed, limit orders for odd-lots, and limit orders that are all-or-none orders. The rules do not require the display of limit orders of block size (10,000 shares or \$200,000) unless the customer requests that the order be displayed.

⁹ 17 CFR 240.11Ac1-1.

¹⁰ See Letter from S. William Broka, Senior Vice President, Trading & Market Service, Nasdaq Stock Market, Inc., dated December 23, 1996.

³³ 15 U.S.C. 78s(b)(2).

³⁴ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

³ Letter from Robert E. Aber, NASD to Robert L.D. Colby, Commission, dated January 9, 1997. The amendment would (1) establish a three month pilot