SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45603; File No. SR–CBOE–00–12]

Self Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change Relating to the Expansion of the Equity Hedge Exemption From Position and Exercise Limits

March 20, 2002.

I. Introduction

On March 31, 2001, the Chicago Board Options Exchange, Inc. (''CBOE'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to expand the current equity hedge exemption to eliminate position and exercise limits for certain qualified hedge strategies.

On July 20, 2001, the CBOE filed Amendment No. 1 with the Commission.[3] The proposed rule change and Amendment No. 1 thereto were published for comment in the **Federal Register** on August 17, 2001.[4] On February 22, 2002, the CBOE submitted Amendment No. 2 to the proposal.[5] The Commission received no comments on the proposal.

II. Description of the Proposal

The Exchange is proposing to eliminate position and exercise limits when certain qualified strategies are employed to establish a hedged equity option position and to establish a position and exercise limit of five times the standard limit for those strategies that include an OTC option contract. Accordingly, the CBOE proposes to amend Interpretation .04 of Exchange Rule 4.11 to expand the definition of a ''qualified'' hedged position. Listed below are the proposed qualified hedge strategies and their accompanying examples.

(i) Positions hedged or covered with the underlying security or securities readily convertible into stock (long call/short stock or short call/long stock or long put/long stock or short put/short stock). This hedge strategy is currently exempt pursuant to the equity hedge exemption provision contained in Exchange Rule 4.11; contracts are covered on a one-for-one basis.

For example, account ABC is short 5,000 GE Apr 35 calls and long 500,000 shares of GE common stock. Account ABC is also short 1,000 GE April 40 calls but has no corresponding stock hedge. The account is exempt on 5,000 contracts hedged with stock and the short 1,000 GE April 40 call position is not considered hedged and thus applied to the applicable position limit.

(ii) Reverse Conversion (buy call/sell put (same expiration)/sell stock).[6] For example, assume account ABC establishes the following position:

Long 25,000 GE April 35 calls
Short 25,000 GE April 35 puts
Short 2,500,000 shares of GE common stock

Under the proposed rule change, two options contracts (*i.e.*, one long call and one short put) will be treated as one contract for hedging purposes. Each reverse conversion option position must be hedged with 100 shares of the underlying security to remain exempt. Account ABC increases its position by establishing a long call position of 5,000 April 40 contracts with no qualified hedge. Option contracts held by account ABC number 55,000 on the short call long put side of the market. The 50,000 contract reverse conversion position is a qualified hedge strategy and is thus exempt from the position and exercise limit. The remaining 5,000 contracts and any future positions established by the account in which a non-qualified strategy is employed would be added to the account's existing 5,000 contract position and applied to the standard position limit.

(iii) Conversion (sell call/buy put (same expiration)/buy stock).[7] The components and hedge treatment of the conversion strategy is the same as the reverse conversion except that the option component of the position is on the short side of the market (*i.e.,* short call, long put) and is hedged with long stock.

(iv) Collar (sell call/buy put, both out-of-the-money when established with the same expiration where the strike price of the short call exceeds the strike price of the long put/buy stock).[8] A collar strategy provides downside protection by the use of put option contracts and finances the purchase of the puts through the sale of short call option contracts. The goal of this strategy is to bracket the price of the underlying security at the time the position is established. For example, assume that the price of an underlying equity, XYZ, is $53 and account ABC is long 5000 shares of XYZ at $53. Account ABC sells 50 XYZ April 55 calls and purchases 50 XYZ April 50 puts. Under the collar exemption, one collar (*i.e.,* one short call, and one long put) must be hedged with 100 shares of the underlying security to remain exempt. Additionally, both call and put components of the option strategy must be out-of-the-money at the time the position is established, both contracts must expire at the same time, and the strike price of the short call must exceed the strike price of the long put position. One leg of the option position (*i.e.*, short call or long put) can be an OTC contract guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account.

(v) Box Spread (buy call, sell put at one strike price, sell call, buy put at another strike price). Assume that account ABC maintains the following position:

Long 5,000 April 35 calls
Short 5,000 April 40 calls
Long 5,000 April 40 puts
Short 5,000 April 35 puts

This position is a qualified box spread and would be exempt from the position limit. Any future option positions established that do not meet the requirements of the qualified hedge strategies would be applied to the account's applicable position limit.

(vi) Listed vs. OTC Options Spreads (options are generally to be within one strike of each other and no more than

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

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Steve Youhn, Legal Division, CBOE, to Nancy Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated July 19, 2001 (''Amendment No. 1''). In response to comments from Commission staff, the Exchange submitted Amendment No. 1, which (i) deletes language contained in Exchange Rule 4.11 Interpretation .04(b) regarding the limitation on the number of contracts that can be maintained under the equity hedge exemption and (ii) includes examples of the proposed qualified hedge strategies.

[4] *See* Securities Exchange Act Release No. 44681 (August 10, 2001), 66 FR 43274.

[5] *See* Letter from Christopher R. Hill, CBOE, to Nancy Sanow, Assistant Director, Division, Commission, dated February 21, 2001 (''Amendment No. 2''). In Amendment No. 2, the CBOE established a position and exercise limit equal to no greater than five times the standard limit for those hedge strategies that include an OTC option component.

[6] For these strategies one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account. Hedge transactions and positions established pursuant to these strategies are subject to a position limit equal to five times the standards limit established under CBOE Rule 4.11, Interpretation .02. For purposes of this rule filing, an OTC option contract is defined as an option that is not listed on a National Securities Exchange or cleared at the Options Clearing Corporation.

[7] *Id.*

[8] *Id.*

one expiration month apart).[9] Member firms that conduct an over-the-counter options business utilize the listed options market to hedge their customer facilitated OTC transactions. It is the CBOE's understanding that some member firms participate in stock buy-back programs whereby the firm purchases OTC put option contracts from the subject corporation, the corporation, in turn, will be assigned its short put position, thereby ''buying back'' its own stock.

To hedge this position, the firm will sell put option contracts in the listed market. For example, Firm ABC purchases 50,000 XYZ puts with a strike price of 63.34 expiring in 1/19/03 from XYZ Corporation. At the expiration of the OTC contract, the firm will sell to XYZ Corporation 5,000,000 shares of its common stock at a price of $63.34. To hedge its position, the firm will sell put option contracts on the CBOE; often at a strike price close to the noted OTC contract with the same expiration date as the OTC contract. OTC contracts hedged on a one-for-one basis against listed option contracts would be exempt from the position limit. As the OTC position generally does not change, the Exchange would require the exempt firm to forward to the Exchange, on the Monday following the monthly expiration, the status of its OTC position.

Within the list of proposed hedge strategies eligible for an equity hedge exemption, the Exchange proposes that the option component of a reversal, conversion, or collar position be treated as one contract rather than as two contracts. All three strategies serve to hedge a related stock portfolio. Because these strategies require the contemporaneous [10] purchase/sale of both a call and put component against the appropriate number of shares underlying the option (generally 100 shares), the Exchange believes that the position should be treated as one contract for hedging purposes.

Under the proposed rule change, the existing standard position and exercise limits will remain in place for unhedged equity option positions. Once an account nears or reaches the standard limit, positions identified as one or more of the proposed qualified hedge strategies will be exempted from limit calculations. The exemption will be automatic (*i.e.*, does not require pre-approval from the Exchange) to the extent that the member identifies that a pre-existing qualified hedge strategy is in place or is employed from the point that an account's position reaches the standard limit and provides the required supporting documentation to the Exchange.

The exemption will remain in effect to the extent that the exempted position remains intact and that the Exchange is provided with any required supporting documentation. Procedures to demonstrate that the option position remains qualified will be similar to those currently in place for equity hedge exemptions. Currently a qualified account must report hedge information each time the option position changes. Hedge information for member firm and customer accounts are reported to the Exchange electronically, via the Large Options Position Report. Market maker account information is also reported to the Exchange electronically by the member's clearing firm. For those option positions that do not change, a filing is generally required on a weekly basis. Finally, the existing requirement imposed on member firms to report hedge information for proprietary and customer accounts that maintain an options position in excess of 10,000 contracts will remain in place.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange [11] and, in particular, the requirements of section 6 of the Act [12] and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with section 6(b)(5) of the Act [13] in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the component securities comprising the indexes. At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market makers from adequately meeting their obligations to maintain a fair and orderly market.[14]

The Commission has carefully considered the CBOE's proposal to expand the hedge exemption from position and exercise limits. Given the market neutral characteristic of all the proposed qualified hedge strategies (except covered stock positions), the Commission believes it is permissible to expand the current equity hedge exemption without risk of disruption to the options or underlying cash markets. Specifically, the Commission believes that existing position and exercise limits, procedures for maintaining the exemption, and the reporting requirements imposed by the Exchange will help protect against potential manipulation. The Commission notes that the existing standard position and exercise limits will remain in place for unhedged equity option positions. To further ensure against market disruption, the CBOE will establish a position and exercise limit equal to no greater than five times the standard limit for those hedge strategies that include an OTC option component.

Once an account nears or reaches the standard limit, positions identified as one or more of the proposed qualified hedge strategies will be exempted from limit calculations. Although the exemption will be automatic (*i.e.*, does not require pre-approval from the Exchange), the exemption will remain in effect only to the extent that the exempted position remains intact and that the Exchange is provided with any required supporting documentation.

In addition, as described above, a qualified account must report hedge information each time the option position changes. Hedge information for member firm and customer accounts are reported to the Exchange electronically, via the Large Options Position Report. Market maker account information is also reported to the Exchange

[9] Hedge transactions and positions established pursuant to this strategy are subject to a position limit equal to five times the standards limit established under CBOE Rule 4.11, Interpretation .02.

[10] At or about the same time.

[11] In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[12] 15 U.S.C. 78f.

[13] 15 U.S.C. 78f(b)(5).

[14] *Id.*

electronically by the member's clearing firm. For those option positions that do not change, a filing is generally required on a weekly basis. Finally, the existing requirement imposed on member firms to report hedge information for proprietary and customer accounts that maintain an options position in excess of 10,000 contracts will remain in place.

The Commission believes these reporting requirements will help the CBOE to monitor options positions and ensure that only qualified hedges are being exempt from position and exercise limits. To the extent that any position raises concerns, the Commission believes that the CBOE, through its monitoring, will be promptly notified, and the Commission would expect the CBOE to take any appropriate action, as permitted by its rules.

The Commission finds good cause, pursuant to section 19(b)(2) of the Act,[15] for approving Amendment No 2 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 2 establishes a position and exercise limit equal to no greater than five times the standard limit for those hedge strategies that include an OTC option component. Setting the position and exercise limit at this level should provide Exchange members greater flexibility in using hedge strategies advantageously, while providing an adequate level of protection against the opportunity for manipulation of these securities and disruption in the underlying market. Accordingly, the Commission finds good cause, consistent with sections 6(b)(5)[16] and 19(b)(2)[17] of the Act to accelerate approval of Amendment No. 2 to the proposed rule change.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether it is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW, Washington, DC 20549–0609. 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 CBOE. All submissions should refer to File No. SR–CBOE–00–12 and should be submitted by April 17, 2002.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[18] that the proposed rule change (File No. SR-CBOE–00–12), as amended, be and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[19]

Margaret H. McFarland,

Deputy Secretary.

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

[16] 15 U.S.C. 78f(b)(5).

[17] 15 U.S.C. 78s(b)(2).

[18] 15 U.S.C. 78s(b)(2).

[19] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–45605; File No. SR–GSCC–2001–10]

Self-Regulatory Organizations; Government Securities Clearing Corporation; Notice of Filing of a Proposed Rule Change Establishing a Loss Allocation Cap for Dealers Acting as Brokers on Substantially All of Their Repurchase Agreement Trades

March 20, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on August 16, 2001, the Government Securities Clearing Corporation (''GSCC'') filed with the Securities and Exchange Commission (''Commission'') a proposed rule change and an on August 31, 2001, amended the proposed rule change as described in Items I, II, and III below, which Items have been prepared primarily by GSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change establishes an account-based loss allocation process for dealers that act as brokers in certain repurchase agreement transactions.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, GSCC included statements concerning the purpose of and basis for the proposed rule changes and discussed any comments it received on the proposed rule changes. The text of these statements may be examined at the places specified in Item IV below. GSCC has prepared summaries, set forth in sections (A), (B) and (C) below, of the most significant aspects of such statements.[2]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

GSCC is proposing to amend its current loss allocation rule concerning non-inter-dealer broker (''dealer'') members who act as brokers in certain of their repurchase agreement (repo) transactions. Under the proposed amended rule, repo transaction accounts of these dealers will be subject to the same $5 million per event absolute loss allocation cap currently applicable to inter-dealer brokers (''IDBs'') instead of an unlimited loss allocation liability. The proposed rule change is designed to afford appropriate relief for these dealers while not unfairly burdening other members.

(i) Current Loss Allocation Procedure

If upon liquidating a defaulting member's positions GSCC incurs a loss due to the failure of the defaulting member to fulfill its obligations to GSCC, GSCC looks to the collateral deposited by that defaulting member to satisfy the loss. If the defaulting member's collateral is insufficient to cover the loss, the defaulting member's most ''recent'' trading partners will be looked to, on a pro rata basis, in order to satisfy the ''remaining loss.''

Before the loss can be allocated to the defaulting member's most ''recent'' trading partners, GSCC must first determine the proportion of the loss that arose in connection with member-brokered transactions and non-member brokered transactions and the proportion that arose in connection with direct transactions.

To the extent the remaining loss is determined by GSCC to arise in connection with member brokered transactions, GSCC's rules provide that fifty percent of the loss will be allocated to netting members that are category 1

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

[2] The Commission has modified parts of these statements.