

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46561; File No. SR-OCC-2002-09]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Fixing Settlement Prices in the Event of Market Disruptions

September 26, 2002.

I. Introduction

On May 17, 2002, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-OCC-2002-09 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").¹ Notice of the proposal was published in the **Federal Register** on August 1, 2002.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

The primary purpose of the proposed rule change is to ensure that OCC will have the ability, in case of market disruptions, to conform settlement prices for OCC-cleared security futures and index options, where appropriate, to settlement prices that are used for related products (such as other futures on the same security or index) traded in other markets and not cleared by OCC. The proposed rule change will primarily affect the fixing of exercise settlement amounts for expiring options as well as final settlement prices for maturing futures contracts.³ OCC does not anticipate any substantive change in its present policy with respect to fixing settlement prices for options that are exercised prior to expiration.⁴

In the event of an interruption in the markets for an underlying security or one or more component securities in an underlying index, OCC needs to have discretion to act to set final settlement values in a manner that avoids inconsistencies between the futures and options markets and among futures markets.⁵ At times, investors employ hedging and other trading strategies that involve holding positions in different contracts on the same underlying security or index. These strategies are based on the expectation that the values of different derivative contracts with the same underlying interest will have a predictable relationship to one another. This expectation may not be met when trading halts or other disruptions in markets for the underlying interests require the derivatives markets to fix settlement prices using prices or values other than those that would normally be used. In such cases, discrepancies in settlement prices can occur unless prices for derivative products traded in different markets are fixed using a common method. Unless such coordination occurs, investors with positions in options and futures that were intended to hedge one another may find that the positions do not produce the anticipated offset.

In the spring of 2000, OCC attempted to solve the problem of a potential disconnect between the options and futures markets in setting final index contract settlement prices by conforming its rules more closely to the rules of the Chicago Mercantile Exchange ("CME") as then in effect.⁶ OCC's rule change broadened the circumstances under which OCC could fix a settlement price for expiring index options to include situations where market disruptions affected one or more

securities in an index (as opposed to "securities representing a substantial portion of the value of an index") and added a paragraph relating solely to expiring options specifically permitting OCC to fix settlement prices based on the next opening prices for one or more component stocks.⁷

Effective December 1, 2001, CME changed its rules governing its method of fixing final settlement prices for each of its index futures products under certain circumstances. CME's newly amended rules provide that if the primary market for a component stock opens for trading on the day scheduled for determination of a final settlement price but the component stock does not trade while the market is open, the price of the component stock for purposes of calculating the final settlement price will be based on the last sale price of the stock *unless* CME's president or his delegate determines that there is a reasonable likelihood that trading in the component stock will occur shortly. In that case, for purposes of determining the final settlement price, the price of the component stock may be based on the opening price of the component stock on the next day the component stock is traded on its primary market.⁸

OCC's existing rules do not authorize OCC to fix a settlement price based on a stock's next opening price in situations where the stock's primary market is open but the stock does not trade. SR-OCC-00-01 authorized the use of opening values only in cases where a stock's primary market did not open or remain open for trading at or before the time when the exercise settlement amount would ordinarily be determined. As a result, OCC is again faced with a potential disconnect between its rules and CME's rules.

The most fundamental aspect of SR-OCC-00-01 was that for the first time OCC was allowed to fix a settlement

⁷ Securities Exchange Act Release No. 42769 (May 9, 2000), 65 FR 31036 (May 15, 2000) [SR-OCC-2000-01].

⁸ For example, CME added the following underlined language to CME Rule 2003.A:

If a component stock in the index does not trade on the day scheduled for determination of the Final Settlement Price while the primary market for that stock is open for trading, the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the last sale price of that stock. *However, if the President of the Exchange or his delegate determines that there is a reasonable likelihood that trading in the stock shall occur shortly, the President or his delegate may instruct that the price of stock shall be based, for the purposes of calculating the Final Settlement Price, on the opening price of the stock on the next day that it is traded on its primary market. Factors to be considered in determining whether trading in the stock is likely to occur shortly shall include the nature of the event and recent liquidity levels in the affected stock.*

¹⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 46265 (July 25, 2002), 67 FR 49973.

³ These will include single stock futures and narrow-based index futures as well as broad-based index futures subject to the exclusive jurisdiction of the Commodity Futures Trading Commission.

⁴ That general policy will be restated in new Interpretation .02 to Section 4 of Article XVII of OCC's by-laws.

⁵ This rule change will affect the fixing of final settlement prices for futures contracts and exercise settlement amounts for options. However, in the case of options exercised other than at expiration, coordination with other markets is ordinarily not a significant factor because either there is no concurrent final settlement in related futures markets or an investor need not exercise the option.

⁶ For example, CME Rule 2003.A., which governs the method for determining the final settlement price for Standard & Poor's 500 Stock Index Futures, provided (at that time) as follows:

If the primary market for a component stock in the index does not open on the day scheduled for determination of the Final Settlement Price, then the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the opening price of that stock on the next day that its primary market is open for trading.

If a component stock in the index does not trade on the day scheduled for determination of the Final Settlement Price while the primary market for that stock is open for trading, the price of that stock shall be determined, for the purposes of calculating the Final Settlement Price, based on the last sale price of that stock.

value based on prices that occurred after an expiration and to treat options that were in the money based upon that subsequently determined price as having been exercised on the expiration date. This rule change makes more explicit the broad scope of OCC's discretion to invoke that authority and the broad discretion that OCC or an adjustment panel (in the case of options) has in fixing final settlement prices and exercise settlement amounts.⁹ The rule change also will make clear that OCC may follow the procedures in CME's current rule and may use either the latest closing prices for individual stocks that fail to trade or use opening prices for the next day on which the stock trades.

The authority to fix final settlement prices for futures and exercise settlement amounts for options in unusual market conditions should be sufficiently broad to ensure that the authority will exist to conform such settlement values to the settlement values established for related products traded in other markets whenever that result is deemed, on balance, to be in the best interest of investors. Experience has shown that this authority must be stated broadly so that if CME or other related markets in the future amend the circumstances in which they can fix settlement values or the means that they use to fix those values, OCC will not need to amend its rules further to conform. Because CME and other markets often do not coordinate with OCC when they change their rules governing the fixing of settlement values, OCC may not be able to conform its rules to amendments made by other markets quickly enough to avoid a disconnect between the futures and options markets. The rule change provides broad discretion both as to the circumstances in which authority would exist to fix a settlement value and the method by which the settlement value would be fixed.

The primary purpose of the rule change is to give OCC broad discretionary authority to adjust settlement values for OCC-cleared index options and futures whenever, and in whatever manner, OCC deems appropriate to avoid a disconnect between the futures and options markets or among the futures markets. It is equally important to note, however, that such coordination is primarily of importance only when OCC-cleared options are exercised on expiration dates or when OCC-cleared futures have maturity dates that coincide with the

expiration, maturity, or delivery dates of related contracts traded in other markets. Accordingly, exercises of index options prior to the expiration date would not necessarily be adjusted to conform to activity in other markets. Finally, even in the case of final settlement values that would ordinarily correspond with final settlement values in other markets, the coordination of such settlement values is not the only factor that OCC (or an adjustment panel) will consider in deciding whether and how to fix settlement values. Accordingly, there could be circumstances where settlement values for OCC-cleared products would not be conformed to prices used in other markets even though the authority would exist to do so.

III. Discussion

Section 19(b)(2)(B) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to protect investors and the public interest.¹⁰ By being able in times of market disruptions to conform settlement prices for security futures and index options to settlement prices that are used for related products traded in other markets, OCC will be able to fix exercise prices to better meet investors' expectations in establishing hedged positions that the values of different derivatives contracts with the same underlying interest will have a predictable relationship to one another. As a result, investors will be better protected from losses resulting from market disruptions. Therefore, OCC's proposed rule change meets the requirements of section 17A(b)(3)(F).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of section 17A of the Act and the rules and regulations thereunder applicable.

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2002-09) be, and hereby is, approved.

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

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46545; File No. SR-Phlx-2002-49]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Extension of PACE Guarantee Exemption

September 24, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 12, 2002, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization.

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 Phlx proposes to amend the first paragraph of Supplementary Material Section .10(a)(iii) of Exchange Rule 229, Philadelphia Stock Exchange Automated Communication and Execution System ("PACE"),³ to extend a current exemption from that provision so that it will be effective for as long as the Commission's exemption from section 8(d) of the ITS Plan issued by Commission Order dated August 28, 2002 (the "ITS Exemption") remains in effect.⁴

¹¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ PACE is the Exchange's Automated Communication and Execution System. PACE provides a system for the automatic execution of orders on the Exchange equity floor under predetermined conditions.

⁴ See Securities Exchange Act Release No. 46428, 67 FR 56607 (September 4, 2002) (Order Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rule 11Aa3-2(f) thereunder Granting A De Minimis Exemption for Transactions in Certain Exchange-Traded Funds from the Trade-Through Provisions of the Intermarket Trading System.). The ITS Plan is a national market system plan approved by the Commission pursuant to Section 11A of the Act and Rule 11Aa3-2 thereunder.

⁹ A supplement to the Options Disclosure Document that describes the substance of the by-law changes proposed herein has been filed with the Commission.

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).