

approval by the Commission of certain features of its Hybrid Market, so that it may begin live systems testing in a limited group of stocks. According to the Exchange, this Pilot is necessary so that the Exchange can maintain its planned implementation schedule for the Hybrid Market and meet the Regulation NMS compliance dates.²⁴ The Commission recognizes that certain of the processes that NYSE has proposed to begin testing have generated comment in the Hybrid Market filings. The Commission wishes to emphasize that it continues to review the larger Hybrid Market filings, including the processes included in this Pilot.²⁵ The Commission is considering all of the comments submitted in response to the Hybrid Market filings and has not reached a decision on whether they should be approved or disapproved. The Commission, however, believes that due to the limited nature of the Pilot and its short duration, that it is consistent with the Act to allow NYSE to begin testing its new systems with this Pilot.

The NYSE explained in its filing that it has tested these functions extensively but that it needs to test them in an actual trading environment to ensure that they operate as intended. Accordingly, NYSE represented that it does not anticipate any significant problems arising from the Pilot. However, NYSE will immediately terminate the Pilot, in whole or in part, as appropriate, should any systems or other problems arise that adversely impact the protection of investors or impede its ability to maintain a fair and orderly market, and return trading to its current operations under current NYSE rules.²⁶

The Commission finds good cause, pursuant to Section 19(b)(2) of the

Act,²⁷ for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice in the **Federal Register**. The Pilot, which as discussed above is limited in scope and duration, will allow the NYSE to conduct real-time system and user testing of certain features of the proposed Hybrid Market. According to NYSE, such testing should be beneficial from both a technology and a training perspective. Although preliminary steps have been taken—the NYSE has provided training for both Floor brokers and specialists, many member organizations also provided firm-specific training for their employees, and proprietary system vendors were able to utilize the NYSE trading environment for their training sessions—the Pilot should give the Exchange the opportunity, in advance of the compliance date of Regulation NMS, to identify and address any system problems with these particular rules under the proposed Hybrid Market. Further, the Pilot should allow users to gain essential practical experience with the new systems and processes. Therefore, the Commission finds that immediate implementation of the Pilot, which is limited in both scope and duration, should permit NYSE to remain on schedule to implement the Hybrid Market filings, if approved by the Commission so that it may meet the Regulation NMS compliance dates.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NYSE-2005-87), as amended, is hereby approved on an accelerated basis until March 14, 2006 or the Commission otherwise acts on the Hybrid Market filings.

By the Commission.

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52951; File No. SR-NYSE-2004-39]

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving a Proposed Rule Change and Partial Amendment No. 1 To Amend Exchange Rule 431 (Margin Requirements)

December 14, 2005.

I. Introduction

On July 12, 2004, the New York Stock Exchange, Inc. (the “Exchange” or “NYSE”) filed with the Securities and Exchange Commission (“SEC” or the “Commission”) a proposed rule change to amend specified provision of Exchange Rule 431 (margin requirements) pursuant to Section 19(b)(1) ¹ of the Securities Exchange Act of 1934 (the “Exchange Act”) ² and Rule 19b-4 thereunder.³ On September 29, 2005, the Exchange filed a partial amendment to its proposed rule change.⁴ The proposed rule change, as amended, was published for comment in the **Federal Register** on November 10, 2005.⁵ The Commission received no comments on the proposal.

II. Description

The Exchange has proposed amendments to Rule 431 (margin requirements) that will recognize specific additional complex option spread strategies and set margin requirements commensurate with the risk of such spread strategies. These complex spread strategies are a combination of two or more basic option spreads that are already covered under Exchange Rule 431. In addition, the Exchange has proposed the elimination of the two-dollar standard exercise price interval limitation for listed options and certain terminology with respect to “permitted offsets,” as defined in its Rule. The proposed amendments described below have been developed in conjunction with the Chicago Board Options Exchange (“CBOE”).

A. Complex Option Spreads

As noted, the Exchange has proposed amendments to Rule 431 to recognize

¹ 15 U.S.C. 78s(b)(1).

² 15 U.S.C. 78a et seq.

³ 17 CFR 240.19b-4.

⁴ SR-NYSE-2004-39: Amendment No. 1. The NYSE, in coordination with the Chicago Board Options Exchange, Incorporated (“CBOE”), filed the partial amendment to conform the complex options spreads strategies to which its rule amendments apply to those of the CBOE.

⁵ See Securities Exchange Act Release No. 52738 (Nov. 4, 2005); 70 FR 68501 (Nov. 10, 2005).

²⁴ NYSE has represented that it has proposed the Hybrid Market with the intent that it will entitle NYSE quotations to protection under Rule 611 as well as to comply with its obligations under this rule. The compliance date for certain rules adopted under Regulation NMS is June 29, 2006. 17 CFR 242.611.

²⁵ The Commission notes that the scope of the Pilot is extremely limited. This Pilot is intended to enable NYSE to technologically test certain features of its Hybrid Market proposal. Other significant features of the Hybrid Market proposal, such as the expansion of Direct+ and the ability of specialists to electronically interact with the Display Book, are not included in this Pilot. The NYSE represented that it expects to be able to use the results of the systems testing in evaluating and addressing any technology issues related to its Hybrid Market proposal that become apparent.

²⁶ The Exchange stated that it would be able to revert back to pre-Pilot operations within an average of two minutes or less. The Exchange will notify the public via its Web site if the Pilot is terminated in whole or in part. In addition, the Exchange will notify floor members at the post if the Pilot is terminated in whole or in part.

²⁷ 15 U.S.C. 78s(b)(2).

certain additional complex option spread strategies that are the net result of combining two or more spread strategies that are currently recognized in the Exchange's margin rules. The netting of contracts in option series common to each of the currently recognized spreads in an aggregation reduces it to the complex spread strategies outlined below.

The Exchange states that basic option spreads can be paired in such ways that they offset each other in terms of risk. The total risk of the combined spreads is less than the sum of the risk of both spread positions if viewed as stand-alone strategies. The specific complex spread strategies listed below are structured using the same principles as, and are essentially expansions of, the advanced spreads currently allowed in Rule 431.

Currently, Rule 431 recognizes and prescribes margin requirements for advanced spread strategies known as the "butterfly spread" and the "box spread." However, the Exchange noted that these option spreads are limited in scope and that its proposal expands upon the types of pairings that would qualify for butterfly spread and box spread treatment.

Exchange Rule 431(f)(2)(G)(i) recognizes "calendar spreads," also known as "time spreads," but these spreads are not identified as such. The Exchange has proposed to define this term as "the sale of one option and the simultaneous purchase of an option with a more distant expiration date, both specifying the same underlying component with the same exercise price where the long options do not expire before the short option with the longest term expiration" in the definition section of the Rule (NYSE 431(f)(2)(C)) because some of the complex spreads recognized in this proposal will include this component of spread strategies.

The Exchange noted that to be eligible for the margin requirements in the proposal, a complex spread must be consistent with one of the seven patterns specified below. The expiration months and the sequence of the exercise prices must correspond to the same pattern, and the intervals between the exercise prices must be equal.

Under the proposal, members and member organizations will be required to obtain initial and maintenance margin for the subject complex spreads, whether established outright or through netting, of not less than the sum of the margin required on each basic spread in the equivalent aggregation.

The Exchange noted that the basic requirements for complex options spreads are as follows: (a) The complex

spreads must be carried in a margin account; (b) European-style options are prohibited for complex spread combinations having a long option series that expires after the other option series. Only American-style options may be used in these combinations.

Additionally, the intervals between exercise prices must be equal, and each complex spread must comprise four option series, with the exception of a Long Calendar Butterfly Spread, which must comprised of three option series.

According to the Exchange, the sum of the margin required on each currently recognized spread in each of the applicable aggregations renders a margin requirement for the subject complex spread strategies as stated below. The additional complex option strategies and maintenance margin requirements are as follows: (1) A Long Condor Spread comprised of two long Butterfly Spreads; (2) a Short Iron Butterfly Spread comprised of one long Butterfly Spread and one short Box Spread; (3) a Short Iron Condor Spread comprised of two long Butterfly Spreads and one short Box Spread; (4) a Long Calendar Butterfly Spread comprised of one long Calendar Spread and one long Butterfly Spread; (5) a Long Calendar Condor Spread comprised of one long Calendar Spread and two long Butterfly Spreads; (6) a Short Calendar Iron Butterfly Spread comprised of one long Calendar Spread plus one long Butterfly Spread and one short Box Spread; and (7) a Short Calendar Iron Condor Spread comprised of one Long Calendar Spread plus two long Butterfly Spreads and one short Box Spread.

The Exchange stated that the purpose and benefit of the proposal is to set levels of margin that more precisely represent the actual net risk of the option positions in the account and to enable customers to implement these strategies more efficiently.

B. Permitted Offsets

Currently, Exchange Rule 431(f)(2)(J) limits permitted offsets⁶ for specialists and market makers in options to option series that are "in-or-at-the-money."⁷ Recently, various options exchanges have provided for the listing of options

with one-dollar strike intervals in a number of classes. The Exchange stated that as a result, the use of securities to hedge option series that have one-dollar strike intervals has unintentionally become more restrictive.

The Exchange has proposed a rule change to eliminate the two-dollar standard exercise price interval limitation for listed options and the definition of "in-or-at-the-money." As proposed, Rule 431(f)(2)(J) would require permitted offset transactions be effected for specialist or market-making purposes such as hedging, risk reduction, rebalancing of positions, liquidation, or accommodation of customer orders, or other similar specialist or market-making purposes, while prohibiting trading in an underlying security that is not related to specialist or market making option activities, or that does not constitute a reasonable hedge.

Because clearing firms have risk monitoring systems that alert them to unhedged positions and haircut requirements pursuant to Rule 15c3-1⁸ of the Exchange Act⁹ perform a similar function as NYSE margin requirements relative to providing adequate risk coverage to broker-dealers, the Exchange believes that the elimination of the two-dollar standard exercise price limitation and definition of "in-or-at-the-money" will not diminish the "safety and soundness" protections that Rule 431 provides.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁰ In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Exchange Act,¹¹ which requires that the rules of the exchange be designed, among other things, to remove impediments to and perfect the mechanisms of a free and open market, and, in general, to protect investors and the public interest. The Commission finds that amending the rules to permit complex option spread strategies that are the net result of combining two or more spread strategies that are currently recognized in the Exchange's margin rules is consistent

⁶ NYSE Rule 431(f)(2)(J) defines a permitted offset position as, in the case of an option in which a specialist makes a market, a position in the underlying asset or other related assets, and in the case of other securities in which a specialist makes a market, a position in options overlying the securities in which a specialist makes a market.

⁷ NYSE Rule 431(f)(2)(J) defines the term "in or at the money" as the current market price of the underlying security is not more than two standard exercise intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option.

⁸ 17 CFR 240.15c3-1.

⁹ 15 U.S.C. 78a.

¹⁰ 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).

¹¹ 15 U.S.C. 78f(b)(5).

with the requirements of Section 6(b)(5) because the amendments will allow the Exchange to set levels of margin that more precisely represent the actual net risk of the option positions in the account and enable customers to implement these strategies more efficiently.

The Commission further finds elimination of the two-dollar standard exercise price interval limitation for listed options and elimination of the definition of "in-or-at-the-money" are consistent with the requirements of Section 6(b)(5). The rules changes should allow specialists and market makers to hedge risk related to their options positions while prohibiting trading in an underlying security that is not related to specialist or market making option activities, or that does not constitute a reasonable hedge.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (File No. SR-NYSE-2004-39), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52935; File No. SR-PCX-2005-127]

Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Exchange Fees and Charges

December 9, 2005.

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 November 25, 2005, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. PCX has designated this proposal as one establishing or changing a due, fee, or other charge imposed by a self-

regulatory organization pursuant to Section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(2) thereunder,⁴ which renders the proposal effective upon filing with the Commission. 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

PCX proposes to amend its Schedule of Fees and Charges in order to include a provision that deals with royalty, or license fees, that are passed on to market participants on options trades that are part of an Option Strategy Execution.

The text of the proposed rule change is available on the Exchange's Internet Web site (<http://www.pacificex.com>), at the Exchange's principal office, and at the Commission's Public Reference Room.

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

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

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

1. Purpose

PCX is proposing this change to the PCX Schedule of Rates and Charges so that the Exchange may continue to pass on the full amount of any royalty or license fees to trade participants, even when total transaction fees are capped in association with a defined Options Strategy Execution. PCX has established a cap on the transaction fees it charges to market participants that engage in certain strategy executions, as defined in the PCX Schedule of Fees and Charges. PCX represents that the cap was established because the referenced Options Strategy Executions are generally large volume trades done by professionals whose profit margins are generally narrow. The Exchange caps

the transaction fees associated with such executions at \$1,000 per strategy execution, with a monthly cap of \$50,000 per initiating firm.

Certain classes of options listed on PCX have as their underlying issue licensed products that carry a royalty fee on every contract traded. These fees are assessed by the issuing agency, and are not Exchange transaction fees. License fees, or royalty fees, that are charged to the Exchange are passed on to the actual participants executing the trade. Even though some of the fees are passed on, the fee cap would prevent PCX from recovering these fees in their entirety if they were to be included as transaction fees. If royalty fees are included as transaction fees, PCX would face the possibility of having to pay out substantial fees while the fee cap would limit the amount the Exchange would be able to pass on to trade participants. Because of the negative financial implications to the Exchange, PCX will not include license or royalty fees, which are passed on to trade participants in connection with trades that are done as part of an Options Strategy Execution, as part of the transaction fees counting towards both the \$1,000 per trade transaction fee cap and the \$50,000 per month fee cap.

2. Statutory Basis

The Exchange believes that proposal is consistent with Section 6(b) of the Act,⁵ in general, and Section 6(b)(4)⁶ in particular, in that it provides for the equitable allocation of dues, fees, and other charges among its members.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

No written comments were solicited or received with respect to the proposed rule change.

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

The foregoing proposed rule change has become effective pursuant to Section 19(b)(3)(A)(ii) of the Act⁷ and

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(2).

⁵ 15 U.S.C. 78f(b).

⁶ 15 U.S.C. 78f(b)(4).

⁷ 15 U.S.C. 78s(b)(3)(A)(ii).