

the proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. 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

This proposal is to amend NYSE Rules 98, 104A.50, 105, and 900 to permit specialists to use exchange-traded single stock futures to hedge existing specialty stock positions in a manner comparable to stock options.

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

The Exchange is proposing to permit specialists to use exchange-traded "security futures"³ overlying single securities (hereinafter referred to as "single stock futures") to hedge specialty stock positions in a manner comparable to stock options. Single stock futures are contracts of sale, traded on a national exchange, such as OneChicago, LLC or Nasdaq Liffe, for the future delivery of a single security.

Rules 105, 98, 104A.50, and 900(d)(v) are proposed to be amended to make reference to "single stock futures" wherever stock options are referenced.

Background

Currently, Rule 105 permits the use by NYSE specialists of options on their specialty stocks subject to certain limitations and restrictions. The rule allows a specialist to acquire and hold, in his specialist trading account, a position in listed options on any of his specialty stocks "where appropriate . . . to offset the risk of making a market

in the underlying stock." Under the rule, a specialist may not establish and maintain an options position which is excessive either in terms of his or her existing position in the underlying specialty stock or in terms of a reasonable estimate of potential losses that may be incurred in relation to any such equity position.

In approving previous amendments to Rule 105, the Commission balanced the regulatory concerns regarding possible stock/option manipulation and the specialists' perceived information advantages against the benefits to the market to be derived from the Rule, namely enhanced market depth and liquidity. The Commission determined that the use of options by NYSE specialists resulted in substantial benefits to the markets for these stocks as well as the options markets.⁴ By analogy, the Commission should determine that the use of single stock futures by specialists would result in similar substantial benefits to the markets for these stocks; this additional hedging mechanism would enable specialists to add to overall stock market liquidity and depth by taking specialty stock positions they might not otherwise assume or by reducing risks on positions they are required to assume.

Proposed Amendments to Rule 105

The Exchange is proposing to amend Rule 105(b) to define a "single stock future" as a contract of sale, traded on a national commodities exchange, for the future delivery of a single security. Appropriate cross-references to "single stock futures" have been added to Rule 105(a)-(d) to reflect that single stock futures can be used wherever options transactions are made.

In addition, paragraph (d) of the Guidelines to Rule 105 (the "Guidelines") would be added to explain the conditions for single stock futures transactions to hedge an existing specialty stock position with a net futures position. As with options, no anticipatory hedging would be allowed; only existing specialty stock positions may be hedged.

The proposed rule (paragraph (d)) states three conditions (similar to options conditions) that single stock futures transactions must meet:

(i) The transaction must result in a net futures position on the *opposite* side of the market from the underlying specialty stock position;

(ii) the transaction must be effected solely to offset the risk of making a

market in the underlying specialty stock; and

(iii) the resulting net futures position must not exceed the number of shares of the specialty stock position that the specialist is offsetting.

Any single stock futures transaction that does not meet *all three* of the above conditions would be deemed to be in violation of Rule 105.

One single stock futures contract would be able to be used to hedge each 100 shares of the existing specialty stock position. (See proposed Rule 105(d), Example 5).

As with options contracts, a hedge that subsequently exceeds the specialty stock position being hedged as a result of 25% or more in the specialist's stock position or which becomes on the same side of the market as the specialty stock position, must be liquidated, unless the equivalent share position is 5000 shares or less. (See proposed paragraph (e) to the Guidelines, Examples 9 and 11).

Similarly, as with options contracts, Rule 105 has been amended to specify that as with options contracts, specialists may also not front-run blocks (paragraph (h) to the Guidelines) and must record futures positions in a separate "memo" account (paragraph (i) to the Guidelines). Additionally, specialists must report to the Exchange: (i) accounts in which single stock futures positions are held (paragraph (j)) and (ii) their positions in single stock futures (paragraph (k)).

Currently, paragraph (l) of the Guidelines to Exchange Rule 105 ("Rule 105(l)") permits an approved person of a specialist to act as a primary market maker or specialist with respect to an option on a specialty stock, provided all the requirements of the Rule 98 exemptive program are met.⁵ This paragraph has been re-lettered as paragraph (m) and incorporates references to market makers in single stock futures contracts. Thus, it is proposed that an approved person of an equity specialist may act as a primary market maker or specialist with respect to a stock futures contract, provided all the requirements of the Rule 98 exemptive program are met.

Paragraph (l) currently prohibits an approved person of an equity specialist acting as a market maker in any equity security in which the associated specialist is registered as such and which underlies an option as to which the approved person acts as an options market maker. Paragraph (l) has been re-

³ The term "security future" is defined in Section 3(a)(55) of the Act. 15 U.S.C. 78c(a)(55).

⁴ See Securities Exchange Act Release No. 28971 (March 13, 1991), 56 FR 11808 (March 20, 1991)(SR-NYSE-90-31).

⁵ See Securities Exchange Act Release No. 45454 (Feb. 15, 2002), 67 FR 8567 (Feb. 25, 2002), approving SR-NYSE-2001-43 and amendments thereto.