

**SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50972; File No. SR-Amex-2004-25)**

January 6, 2005

Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Amendments No. 1 and No. 2 Thereto by the American Stock Exchange LLC Relating to Revisions to Amex Rule 111

I. Introduction

On April 28, 2004, the American Stock Exchange LLC (“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 to amend Amex Rule 111. On May 10, 2004, the Exchange submitted Amendment No. 1 to the proposed rule change.³ On June 8, 2004, the Exchange submitted Amendment No. 2 to the proposed rule change.⁴ The proposed rule change and Amendments Nos. 1 and 2 were published for comment in the Federal Register on October 25, 2004.⁵ No comments were received on the amended proposal.

This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Bill Floyd-Jones, Counsel, Exchange, to Nancy Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated May 7, 2004 (“Amendment No. 1”). In Amendment No. 1, the Exchange clarified the proposed rule language, and provided additional explanation in the purpose section of the proposed rule change.

⁴ See Letter from Bill Floyd-Jones, Counsel, Exchange, to Nancy Sanow, Assistant Director, Division, Commission, dated June 7, 2004 (“Amendment No. 2”). In Amendment No. 2, the Exchange added a definition of “bona fide hedge” to the text of the proposed rule change. In Amendment No. 2, the Exchange also reprinted pages 33 – 35 of Securities Exchange Act Release No. 15533 (January 29, 1979) as proposed Commentary .13 to the text of the proposed rule change.

⁵ See Securities Exchange Act Release No. 50552 (October 15, 2004), 69 FR 62308.

II. Description

A. Background

The original Act gave the Commission the authority to regulate “floor trading”⁶ by members of national securities exchanges.⁷ In 1964, the Commission exercised this authority by adopting SEC Rule 11a-1 – “Regulation of Floor Trading.”⁸ Rule 11a-1 provided, with certain exceptions, that no member of a national securities exchange, while on the floor of such exchange, could initiate any transaction in any security admitted to trading on the exchange, for an account in which such member had an interest. One of the exceptions permitted member transactions for their own account if such transactions were executed in conformity with a Commission-approved exchange plan designed to eliminate floor trading activities that were not beneficial to the market.

⁶ The Commission has defined “floor trading” as trading by members of national securities exchanges for their own account while personally present on the trading floor of an exchange. See Securities Exchange Act Release No. 7290 (April 9, 1964), 29 FR 5168 (April 15, 1964).

⁷ As originally adopted, Section 11(a) of the Act provided:

The Commission shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, (1) to regulate or prevent floor trading by members of national securities exchanges, directly or indirectly for their own account or for discretionary accounts, and (2) to prevent such excessive trading on the exchange but off the floor by members, directly or indirectly for their own account, as the Commission may deem detrimental to the maintenance of a fair and orderly market. It shall be unlawful for a member to effect any transaction in a security in contravention of such rules and regulations, but such rules and regulations may make such exemptions for arbitrage transactions, for transactions in exempted securities, and within the limitations of subsection (b) of this section, for transactions by odd-lot dealers and specialists, as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

⁸ See Securities Exchange Act Release No. 7330 (June 2, 1964), 29 FR 7380 (June 6, 1964).

Shortly after the adoption of SEC Rule 11a-1, the Exchange submitted a floor trading plan (“Plan”).⁹ As part of the Plan, the Exchange proposed Amex Rules 110, 111, and 112, which (1) created a registered equity trader program, and (2) incorporated the trading exemptions found in SEC Rule 11a-1(b)(1) through (b)(6). On July 23, 1964, the Commission approved the Exchange’s Plan,¹⁰ together with revisions to the Plan that exempted from the prohibitions contained in SEC Rule 11a-1 and the Plan: (1) transactions in bonds, (2) hedging transactions by rights specialists in the underlying security, and (3) certain block transactions.¹¹

Generally, Amex Rule 110 prohibits any member from initiating transactions while on the floor for an account in which such member has an interest unless such member is registered as a “Registered Trader.” Registered Traders are limited in the transactions they may initiate on the floor under Amex Rule 111. For example, Registered Traders must meet stabilization tests, may not act as a broker for off-floor orders in stocks in which such Registered Trader has initiated transactions for his own account, and may not retain priority over off-floor orders when establishing or increasing positions in his own account. Amex Rule 111(f)(1) through (6) exempts certain member transactions from the Registered Trader requirements set forth in Amex Rules 110 and 111 and reflects the exemptions from Rule 11a-1(b)(1) through (6). For example, transactions by registered specialists in their specialty stock, transactions by odd-lot

⁹ Securities Exchange Act Release No. 7359 (June 30, 1964), 29 FR 9344 (July 8, 1964).

¹⁰ Securities Exchange Act Release No. 7374, 29 FR 10632 (July 30, 1964).

¹¹ Securities Exchange Act Release No. 7375 (July 23, 1964), 29 FR 10632 (July 30, 1964).

dealers, and bona fide arbitrage transactions of members are not subject to the restrictions set forth in Amex Rules 110 and 111.

In 1975, Congress substantially amended Section 11(a) of the Act¹² by extending the general prohibition on member floor trading embodied in SEC Rule 11a-1¹³ to off-floor member trading. Specifically, Section 11(a) of the Act prohibits, subject to certain exceptions, any member of an exchange from effecting any transaction on such exchange for its own account, the account of an associated person or an account with respect to which it or an associated person thereof exercises investment discretion. The statutory exemptions to the general prohibition found in Section 11(a)(1) of the Act include, among other things, bona fide arbitrage and bona fide hedge transactions. These exceptions reflect Congress' belief that these types of trading activities either contributed to the maintenance of fair and orderly markets, or at least had not given rise to serious abuse.¹⁴

B. Proposed Rule Change

The Exchange proposes to amend Amex Rule 111 to conform it to the 1975 amendments to Section 11(a) of the Act by allowing members registered as options specialists and registered options traders (“ROTs”) to initiate, while on the Amex floor, bona fide hedging transactions for their accounts in Amex listed securities and to allow members registered as equity specialists to initiate, while on the Amex floor, bona fide hedging transactions for their accounts in options traded on Amex. Currently, as noted

¹² See 15 U.S.C. 78k(a).

¹³ 17 CFR 240.11a-1.

¹⁴ See Securities Act Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 99 (1975).

above, Amex members can execute transactions on the floor for accounts in which they have an interest only if they are Registered Traders. The proposed rule change would permit equity specialists, options specialists, and ROTs to initiate bona fide hedge transactions without having to register as Registered Traders and without being subject to the limitations set forth in Amex Rules 110 and 111.¹⁵

Under the Exchange's proposed rule change, options specialists and ROTs could give an order for their account directly to an Amex broker on the floor for a security underlying an option in which they are registered for the purpose of acquiring or liquidating a bona fide hedge position through a trade on the Exchange. Similarly, Amex proposes to permit equity specialists (subject to Amex Rule 175, which regulates option transactions by equity specialists) to give an order for their account directly to an Amex broker on the floor for a security overlying an equity in which they are registered for the purpose of acquiring or liquidating a bona fide hedge position through a trade on the Exchange.

The proposed rule would exempt bona fide hedge transactions in securities underlying options by option specialists and ROTs from the requirements of Amex Rule 110, and paragraphs (a) through (e) of Amex Rule 111. Likewise, the proposed rule would exempt bona fide hedge transactions in options overlying securities by equity specialists from the requirements of Amex Rules 110, 111, and 958 (which regulates the transactions of ROTs).

The Exchange also proposes under Amex Rule 111(i) to add a definition of "bona fide hedge" which shall have the meaning found in SEC Rule 11a1-3(T) and in pages

¹⁵ Amex Rules 110 and 111 apply to options transactions pursuant to Amex Rules 950(a) and 958.

33–35 of the release adopting that rule.¹⁶ The Exchange further proposes to provide a reprint of pages 33 – 35 of the 1979 Release in proposed Commentary .13 of Amex Rule 111.

Brokers who receive orders from equity specialists, options specialists or ROTs would be required to prepare a record of any bona fide hedge order given to them,¹⁷ and specialists and ROTs who give bona fide hedge orders to brokers would have to prepare and submit to the Exchange a record of all such orders and transactions effected for an account in which they have an interest.¹⁸

III. Discussion

After careful consideration, 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,¹⁹ and, in particular, the requirements of Section 6(b)(5) of the Act,²⁰ which requires that the rules of a national securities exchange be designed to, among other things, prevent fraudulent and manipulative acts and practices, and promote just and equitable principles of trade. In addition, the Commission believes that the Amex’s proposal is consistent with Section 11(a) of the Act.

¹⁶ See Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6084, 6090-6091 (January 31, 1979) (“1979 Release”).

¹⁷ See Amex Rule 153.

¹⁸ See Amex Rules 957 and 175, Guidelines for Specialists’ Specialty Option Transactions Pursuant to Rule 175, paragraph (j).

¹⁹ In approving the proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁰ 15 U.S.C. 78f(b)(5).

Specifically, Amex proposes to allow its members to effect a certain type of proprietary transaction on the Amex floor that is currently permitted under the Act. Section 11(a)(1)(D) of the Act allows members of a national securities exchange to engage in “any bona fide hedge transaction involving a long or short position in an equity security and a long or short position in a security entitling the holder to acquire or sell such equity security.”²¹ The Commission has defined bona fide hedge transactions for the purposes of Section 11(a)(1)(D) of the Act.²² In the 1979 Release, the Commission stated that, while the application of the term is largely a matter of custom and practice, the term bona fide hedge implied “an appreciable offset of risk, for all or part of the position being hedged.”²³ The Commission continued, in the 1979 Release, to describe whether particular combinations of stock and options positions would result in risk reduction, the timing of hedging transactions, and the liquidation of hedge positions.²⁴

Amex has proposed to adopt the Commission’s definition of bona fide hedge set forth in the 1979 Release and in Rule 11a1-3(T). Accordingly, the Commission believes that Amex’s proposed definition is consistent with the requirements of the Act. As noted above, the Commission’s definition is specific as to the types and sizes of transactions that can be considered bona fide hedges, the timing of executing hedge transactions and liquidating hedge positions. Amex must ensure that the bona fide hedge transactions executed by specialists and ROTs comply with these requirements for Section 11(a)

²¹ 15 U.S.C. 78k(a)(1)(D). The Commission also has extended the bona fide hedge definition to options to options hedging. See 17 CFR 240.11a1-3(T).

²² See 1979 Release, supra note 16, at 6090-6091.

²³ See id. at 6090.

²⁴ See id. at 6090-6091.

exemption purposes.²⁵ Amex must also ensure that equity specialists continue to comply with Amex Rule 175, which regulates option transactions by equity specialists.

The Commission notes that the Exchange's proposed rule change does not alter the general prohibition on side-by-side trading²⁶ and integrated market making²⁷ on the Exchange.²⁸ Accordingly, equity specialists may not act as specialists or ROTs in options overlying the stocks in which they are registered, and options specialists and ROTs may not act as specialists in the securities underlying the options in which they are registered. Furthermore, Amex may not move the location of stock and options trading posts such that related stocks and options are traded at the same or adjacent locations on the floor.²⁹

²⁵ For example, in the 1979 Release, the Commission noted that to the extent that a position more than offsets the risk of the position to be hedged, the excess position would not be part of a bona fide hedge for the purposes of Section 11(a)(1)(D) of the Act. See id. at 6091.

²⁶ "Side-by-side trading" refers to the trading of securities and related derivative products at the same location, though not necessarily by the same specialist. See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232, 48233, note 9 (July 23, 2002).

²⁷ "Integrated market making" refers to the trading of securities and related derivative products by the same specialist or specialist firm. See id. at 48233, note 10.

²⁸ The Commission notes that, currently, specified exchange-traded funds and trust issued receipts and their related options may be traded on the Amex by the same Exchange specialist or specialist firm without informational or physical barriers or other restrictions. See id. at 48236.

²⁹ See Securities Exchange Act Release No. 26147 (October 3, 1988), 53 FR 39956 (October 7, 1988).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁰ that the proposed rule change (SR-Amex-2004-25), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³¹

J. Lynn Taylor
Assistant Secretary

³⁰ 15 U.S.C. 78s(b)(2).

³¹ 17 CFR 200.30-3(a)(12).