arrangements with other members or member organizations. Notice of the proposal appeared in the **Federal Register** on December 23, 1994.³ No comment letters were received on the proposed rule change. The Exchange filed Amendment No. 1 to the proposal on January 25, 1995.⁴ This order approves the Exchange's proposal, as amended.

The Exchange is proposing several amendments to Exchange Rule 6.40 (Financial Arrangements of Market Makers). First, the Exchange is proposing to change its definition of 'financial arrangement." Specifically, instead of relying on the Exchange's definition of financial arrangement under Rule 4.18,5 a financial arrangement for purposes of Rule 6.40 would exist if one member directly finances the other member's dealings upon the Exchange and has a beneficial interest in the other member's trading account such that the first member is entitled to at least ten percent of the second member's trading profits. In the alternative, a financial arrangement will be deemed to exist under Rule 6.40(a) where two members trade for the same joint account.

Second, the Exchange proposes to modify Rule 6.40(b) to provide that two floor officials, on the basis of demonstrated need, may grant a written exemption⁶ to the trading restrictions imposed by the rule.⁷

Finally, the Exchange proposes to add several commentaries to Rule 6.40. Proposed Commentary .03 merely provides that for purposes of Rule 6.40(a), the term "member" includes members and member organizations.

Proposed Commentary .04 states the purpose of Rule 6.40 and further provides that any market makers who

are not technically covered by the terms of Rule 6.40, but who unfairly dominate the market in any class of options, will be considered to be in violation of their obligation to contribute to the maintenance of fair and orderly markets and to act in accordance with just and equitable principles of trade.

Proposed Commentary .05 codifies the Exchange's existing policy that two or more Lead Market Makers ("LMMs") who are trading on behalf of the same member organization may not bid, offer, and/or trade in the same option series at the same time. Commentary .05 further provides that two or more LMMs who do not have financial arrangements with each other are permitted to bid, offer and/or trade in the same option series at the same time.⁸

Proposed Commentary .06 provides that exemptions to the trading restrictions in Rule 6.40(b) may ordinarily be granted by two floor officials for the purpose of providing liquidity in a trading crowd or where the individual situation otherwise warrant such action. Commentary .06 further provides that an exemption granted pursuant to Rule 6.40(b) generally will not extend beyond the trading day on which it is issued. Moreover, Commentary .06 provides that the Exchange's Options Floor Trading Committee ("Committee") will review, on a regular basis, the exemptions granted pursuant to Rule $6.40(\bar{b}).9$

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, and, in particular, the requirements of Section 6(b)(5).10 Specifically, the Commission finds, as it did in originally approving Rule 6.40,11 that full disclosure of financial arrangements among PSE market makers, members, and member organizations helps the Exchange to better identify and deter potential trading abuses among affiliated PSE members and member organizations. In addition, with such disclosure, the Exchange's ability to monitor the financial condition of its members and member organizations is enhanced. The Commission believes that the proposed amendments to Rule 6.40 do not detract

from these benefits in any material manner and thus, are consistent with the Act.

The Commission believes that it is appropriate for the Exchange to amend the definition of "financial arrangement" to focus more on the nature of the financial interest that a member may have in a market maker's trading account. The Commission believes that the amended definition will help the Exchange to achieve a balance whereby it can still restrict the types of activity for which the rule was intended without unnecessarily removing liquidity from its trading crowds. Commentary .04 furthers this by clarifying the purpose of the rule and providing that unfair domination by market makers subject to financial arrangements that technically are not covered by the amended definition will be considered a violation of just and equitable principles of trade. 12 The Commission believes that Commentary .06 is also consistent with this goal by providing that exemptions to the trading restrictions in Rule 6.40(b) may ordinarily be granted for purposes of providing liquidity in a trading crowd.

On balance, the Commission believes that the trading restrictions in Rule 6.40 should continue to help to preclude collusive trading activity and increase public confidence in the markets while the proposed amendments to Rule 6.40 will allow PSE market makers to continue to respond to trading conditions in all options classes on the Exchange floor without adversely affecting the liquidity of the Exchange's options markets.

The Commission finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. As discussed above, the Commission believes that Proposed Commentary .07 was merely a restatement of the general proposition that in considering appropriate sanctions for violation of Exchange rules, the Exchange (and appropriate committees) may consider mitigating factors, such as whether a violation was inadvertent. As a result, the Commission believes that deleting this language from Rule 6.40 does not raise any new regulatory concerns. Accordingly, the Commission believes that it is consistent with Section 6(b)(5)of the Act to approve Amendment No.

³ See Securities Exchange Act Release No. 35107 (December 16, 1994), 59 FR 66395 (December 23, 1994)

⁴In Amendment No. 1, the Exchange deleted proposed Commentary .07 from PSE Rule 6.40, regarding inadvertent violations of Rule 6.40. See Letter from Michael Pierson, Senior Attorney, Market Regulation, PSE, to Brad Ritter, Senior Counsel, Office of Market Supervision, Division of Market Regulation, Commission, dated January 25, 1995 ("Amendment No. 1").

⁵ Rule 4.18 requires disclosure to the Exchange of certain financial arrangements of members. For these purposes, a financial arrangement is defined as: (1) The direct financing of a member's dealings upon the Exchange; or (2) any direct equity investment or profit sharing arrangement; or (3) any consideration over the amount of \$5,000 that constitutes a gift, loan, salary, or bonus. See PSE Rule 4.18(a).

⁶This amendment merely changes the word "dispensation" to "exemption."

⁷ The Exchange also proposes non-substantive amendments to Rule 6.40(b) by deleting subsections (b)(2) and (b)(3) and adding to subsection (b)(1) the restriction on bidding, offering, and/or trading in the same option series at the same time.

⁸ See generally PSE Rule 6.82 (Lead Market Maker System Pilot Program).

⁹ This requirement is presently set forth in Rule 6.40(c). To avoid repetition, the Exchange also proposes to delete Rule 6.40(c) and renumber rule 6.40(d)

¹⁰ 15 U.S.C. § 78f(b)(5) (1988).

¹¹ See Securities Exchange Act Release No. 32775 (August 20, 1993), 58 FR 45368 (August 27, 1993).

¹² The Commission also notes that as with other PSE rules, in considering appropriate sanctions for violations of Rule 6.40, the Exchange can consider mitigating factors, such as whether a violation was inadvertent. See Amendment No. 1, *supra* note 4.