

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46370; File No. SR-CBOE-2002-29]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. Relating to the Listing and Trading of Index-Linked Exchangeable Notes

August 16, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 7, 2002, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed Amendment No. 1 on August 12, 2002.<sup>3</sup> The Exchange filed Amendment No. 2 on August 16, 2002.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and to grant accelerated approval to the proposed rule change and Amendments Nos. 1 and 2 thereto.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt listing standards for a new product to be known as index-linked exchangeable notes. The text of the proposed rule change, as amended, follows. Additions are in *italics*.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> On August 12, 2002, the Exchange filed a Form 19b-4, which replaced the original filing in its entirety ("Amendment No. 1"). In Amendment No. 1, the Exchange corrected typographical errors and amended the proposed rule text to conform it to those previously approved by both the American Stock Exchange LLC ("Amex") and the Philadelphia Stock Exchange, Inc. ("Phlx"). See Securities Exchange Act Release No. 44621 (July 30, 2001), 66 FR 41064 (August 6, 2001); and Securities Exchange Act Release No. 45082 (November 19, 2001), 66 FR 59282 (November 27, 2001).

<sup>4</sup> See letter from Jim Flynn, Attorney, CBOE, to Florence Harmon, Senior Special Counsel, Division of Market Regulation ("Division"), Commission, dated August 15, 2002 ("Amendment No. 2"). In Amendment No. 2, CBOE made a change to the proposed rule text to conform it to those previously approved by both the Amex and Phlx. See Securities Exchange Act Release No. 44621, *supra* note 3; and Securities Exchange Act Release No., *supra* note 3.

## CHAPTER I

### Definitions

Rule 1.1 (a)-(yy) No Change.

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\* \* \* Interpretation and Policies:

.01-.04 No Change.

.05 The term Index-Linked

Exchangeable Note means an exchangeable debt security that is exchangeable at the option of the holder (subject to the requirement that the holder in most circumstances exchange a specified minimum amount of notes), on call by the issuer, or at maturity for a cash amount based on the reported market prices of the underlying stocks of an underlying index.

\* \* \* \* \*

Rule 31.5 (A)-(N) No Change.

(O) *Index-Linked Exchangeable Notes*

*Index-Linked Exchangeable Notes, which are debt securities that are exchangeable at the option of the holder (subject to the requirement that the holder in most circumstances exchange a specified minimum of notes), on call by the issuer or at maturity for a cash amount ("Cash Amount") based on the reported market prices of underlying stocks of an underlying index, will be considered for listing and trading on the Exchange pursuant to Rule 19b-4e under the Securities Exchange Act of 1934, provided:*

(a) Both the issue and the issuer of such security shall meet the criteria set forth in Rule 31.5(F)(a)-(c), except that the minimum public distribution shall be 150,000 notes with a minimum of 400 public note-holders, except if traded in thousand dollar denominations, then no minimum number of holders.

(b) The notes have an original term to maturity of one year.

(c) Index-linked exchangeable notes will be treated as equity securities for margin and all other purposes.

(d) The issuer shall be expected to have a minimum tangible net worth in excess of \$250,000,000 and to otherwise substantially exceed the earnings requirements set forth in Rule 31.5(A)(2). In the alternative, the issuer will be expected:

(i) *To have a minimum tangible net worth of \$150,000,000 and to otherwise substantially exceed the earnings requirements set forth in 31.5(A)(2); and*

(ii) *Not to have issued index-linked exchangeable notes where the issue price of all the issuer's other index-linked exchangeable note offerings (combined with other index-linked exchangeable note offerings) listed on a national securities exchange or traded through the facilities of Nasdaq exceeds*

*25% of the issuer's net worth. In the case of an issuer which is unable to satisfy the earnings criteria set forth in CBOE Rule 31.5(A)(2), then the Exchange generally will require the issuer to have the following: (i) Assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (ii) assets in excess of \$100 million and stockholders' equity of at least \$20 million.*

(e) Any index to which an exchangeable note is linked shall either be: (i) An index that has been created by a third party and has been approved for the trading of options or other derivative securities (each, a "Third Party Index") either by the Commission under section 19(b)(2) of the Securities Exchange Act of 1934, as amended ("Act") and the rules thereunder or by the Exchange under rules adopted pursuant to Rule 19b-4(e); and, additionally, the securities underlying the Third Party index must be issued by a company that has a continuous reporting obligation under the Act and the security must be listed on a national securities exchange or the Nasdaq National Market and be subject to last sale reporting pursuant to Rule 11Aa3-1 under the Act, and the Third Party Index shall comply with Rule 24.2(b)(12); or (ii) an index in which the issuer has created and for which an Exchange will have obtained approval from either the Commission pursuant to Rule 19(b)(2) and rules thereunder, or from the Exchange under rules adopted pursuant to Rule 19b-4(e). The Issuer Indices and their underlying securities must meet one of the following:

(i) *The procedures and criteria set forth in CBOE Rule 24.2(b)-(c); or*

(ii) *The criteria set forth in CBOE Rules 31.5(I)(d)-(i), Interpretation and Policies .04 and .06 to Rule 31.5(I), Rule 24.2(b)(12), and the index concentration limits so established in CBOE Rule 24.2(b)(6) and Rule 24.2(c)(1) as it relates to Rule 24.2(b)(12).*

(f) *Beginning twelve (12) months after the initial issuance of a series of index-linked exchangeable notes, the Exchange will consider the suspension of trading in or removal from listing of that series of index-linked exchangeable notes under any of the following circumstances:*

(i) *If the series has fewer than 50,000 notes issued and outstanding;*

(ii) *If the market value of all index-linked exchangeable notes of that series issued and outstanding is less than \$100,000,000; or*

(iii) *If such other event shall occur or such other condition exists which in the opinion of the Exchange makes further dealings on the Exchange inadvisable.*

\* \* \* *Interpretations and Policies:*

.01 *The Exchange will not consider for listing any index-linked exchangeable note linked to an unsponsored ADR without the prior consent of the Commission staff.*

.02 *In the event the Exchange wants to list an index-linked exchangeable note which will pay interest at a floating rate, the Exchange will notify the Commission staff before listing such index-linked exchangeable note.*

.03 *Each member organization transacting business on behalf of customers in index-linked exchangeable notes must comply with the requirements of Rule 30.50(c) concerning a member organization's duty to know its customers and approve its customers' accounts.*

\* \* \* \* \*

## 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 III 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

CBOE proposes to adopt listing standards for Index-Linked Exchangeable Notes. Under CBOE Rule 31.5(F) (*Other Securities*), the Exchange may approve for listing and trading, securities which cannot be otherwise covered by the listing criteria for common and preferred stocks, bonds, debentures, or warrants. CBOE now proposes to list for trading, under new Exchange Rule 31.5(O), index-linked exchangeable notes that are designed to allow investors to hold a single, exchange-listed note exchangeable for the cash value of the underlying stocks ("Underlying Stocks") of an index ("Underlying Index," or "Index") and thereby acquire, in a single security and single trade, exposure to a specific index of Underlying Securities.

### A. Index-Linked Exchangeable Notes Generally

*Description.* Index-Linked Exchangeable Notes are debt securities that are exchangeable at the option of the holder (subject to the requirement that the holder in most circumstances exchanges a specified minimum amount of notes), on call by the issuer, or at maturity for a cash amount (the "Cash Value Amount") based on the reported market prices of the underlying stocks of an underlying index. Each index-linked exchangeable note is intended to provide investors with an instrument that closely tracks the Underlying Index. Notwithstanding that the notes are linked to an index, they will trade as a single security. The linkage is on a 1-to-1 basis so that a holder of notes is fully exposed to depreciation and appreciation of the Underlying Stocks.<sup>5</sup> The Exchange will disseminate, on a real-time basis for each series of index-linked exchangeable notes, an estimate, updated every 15 seconds, of the value of a note of that series.<sup>6</sup> This will be based, for example, upon current information regarding the value of the Underlying Index. The value for any newly created index shall be disseminated by the Exchange on a real time basis and updated every 15 seconds.

Index-linked exchangeable notes are expected to trade at a lower cost than the cost of trading each of the Underlying Stocks separately,<sup>7</sup> and also to give investors the ability to maintain index exposure without any management or administrative fees and ongoing expenses. The initial offering price for an index-linked exchangeable note will be established on the date the note is priced for sale to the public. In addition, unlike many hybrid products, index-linked exchangeable notes will not include embedded options or leverage. Because index-linked exchangeable notes are debt securities, holders will not be recognized by issuers of the Underlying Stocks as the owner of those stocks and holders will have no rights as a stockholder with respect to those stocks.

Additional issuances of series of index-linked exchangeable notes may be made subsequent to the initial issuance

<sup>5</sup> Telephone conversation between Jim Flynn, Attorney, CBOE, and Christopher Solgan, Law Clerk, Division, Commission, on August 15, 2002.

<sup>6</sup> Where the Issuer of the index-linked exchangeable note disseminates the estimate of the value of the note through another exchange, the CBOE will ensure that such value is being disseminated by such other exchange on a real-time basis and updated every 15 seconds.

<sup>7</sup> CBOE forwards that this would be due to reduced commission and custody costs.

of that series, and prior to the maturity of that series, for purposes of providing market liquidity. Each series of index-linked exchangeable notes may or may not provide for quarterly interest coupons based on dividends or other cash distributions paid on the Underlying Stocks during a prescribed period and an annual supplemental coupon based on the value of the Underlying Index during a prescribed period. Index-linked exchangeable notes will generally be acquired, held, or transferred only in round-lot amounts, or multiples thereof, of 100 notes, although odd-lot orders are permissible.

Beginning on a specified date, and up to a specified date prior to the maturity date or any call date, the holder of an index-linked exchangeable note may exchange some or all of its index-linked exchangeable notes for their Cash Value Amount plus any accrued, but unpaid, quarterly interest coupons. Holders will generally be required to exchange a certain specified minimum amount of index-linked exchangeable notes, although this minimum requirement may be waived following a downgrade in the issuer's credit rating below specified thresholds or the occurrence of other specified events.

Index-linked exchangeable notes may be subject to call by the issuer on specified dates or during specified periods, upon at least 30, but not more than 60, days notice to holders. The call price would be equal to the Cash Value Amount, plus any accrued but unpaid quarterly interest coupons.

At maturity, the holder of an index-linked exchangeable note will receive a cash amount equal to the Cash Value Amount plus any accumulated, but unpaid, quarterly and annual supplemental interest coupons. Although a specific maturity date will not be established until the time of the initial offering of a series of index-linked exchangeable notes, the index-linked exchangeable notes will provide for maturity within a period of not less than one nor more than thirty years from the date of issue.

### B. Criteria for Initial and Continued Listing

*Initial Listing.* In connection with the initial listing of each series of index-linked exchangeable notes, at the time trading would begin, both the issue and issuer of such security must meet the criteria set forth in Rule 31.5(F), except that the minimum public distribution shall be 150,000 notes with a minimum of 400 public note-holders, and, if traded in thousand dollar denominations, then no minimum number of holders is required.

*Continued Listing.* Beginning twelve months after the initial issuance of a series of index-linked exchangeable notes the Exchange will consider the suspension of trading in, or the removal from listing of, those series of index-linked exchangeable notes upon the occurrence of any of the following circumstances: (i) If the series has fewer than 50,000 notes issued and outstanding; (ii) if the market value of all index-linked exchangeable notes of that series issued and outstanding is less than \$1 million; or (iii) if such other event shall occur or such other condition exist which, in the opinion of the Exchange, makes further dealings on the Exchange unadvisable.

### C. Eligibility Standards for Issuers

The following standards shall apply to each issuer of index-linked exchangeable notes:

(i) *Assets/Equity:* The issuer shall have assets in excess of \$100 million and stockholders' equity of at least \$10 million. In the case of an issuer that is unable to satisfy the earnings criteria set forth in the first sentence of CBOE Rule 31.5(A)(2), the Exchange generally will require the issuer to have the following: (A) Assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (B) assets in excess of \$100 million and stockholders' equity of at least \$20 million.

(ii) *Distribution:* Minimum public distribution of 150,000 notes with a minimum of 400 public noteholders, except, if traded in thousand dollar denominations, then no minimum number of holders.

(iii) *Principal Amount/Aggregate Market Value:* Not less than \$4 million.

(iv) *Tangible Net Worth:* The issuer will be expected to have a minimum tangible net worth in excess of \$250 million, and to otherwise substantially exceed the earnings requirements set forth in CBOE Rule 31.5(A)(2). In the alternative, the issuer will be expected: (A) To have a minimum tangible net worth of \$150 million, and to otherwise substantially exceed the earnings requirements set forth in CBOE Rule 31.5(A)(2); and (B) not to have issued index-linked exchangeable notes where the original issue price of all the issuer's other index-linked exchangeable note offerings (combined with other index-linked exchangeable note offerings of the issuer's affiliates) listed on a national securities exchange or traded through the facilities of Nasdaq exceeds 25% of the issuer's net worth.

### D. Description of the Underlying Indices

Underlying Indices will either be: (i) Indices that have been created by a third

party and have been reviewed and approved for the trading of options or other derivative securities (each, a Third Party Index) either by the Commission under Section 19(b)(2) of the Act,<sup>8</sup> and the rules thereunder, or by the Exchange under rules adopted pursuant to Rule 19b-4(e),<sup>9</sup> or (ii) indices which the issuer has created and for which an Exchange will have obtained approval either from the Commission pursuant to Section 19(b)(2) of the Act,<sup>10</sup> and rules thereunder, or from the Exchange under rules adopted pursuant to Rule 19b-4(e)<sup>11</sup> ("Issuer Index").

All changes to an Underlying Index, including the deletion and addition of Underlying Stocks, index rebalancing, and changes to the calculation of the index, will be made in accordance with the Commission's Section 19(b)(2) order or the Exchange rules under which that index was approved, as the case may be.

The Underlying Index will be calculated based on either the market capitalization, modified market capitalization, price, equal-dollar, or modified equal-dollar weighting methodology. If the issuer or a broker-dealer is responsible for maintaining (or has a role in maintaining) the Underlying Index, it would be required to erect and maintain a "Fire Wall," in a form satisfactory to the Exchange, to prevent the flow of information regarding the Underlying Index from the index production personnel to the sales and trading personnel, and the index must be calculated by a third party who is not a broker-dealer.

### E. Eligibility Standards for Underlying Stocks

The following standards shall apply to each Underlying stock:

(i) *General Criteria:* Each issuer of an Underlying Stock shall be an Exchange Act reporting company that is listed on a national securities exchange or is traded through the facilities of a national securities association and is subject to last sale reporting.

(ii) *Criteria Applicable to Underlying Stocks of Third-Party Indices:* In addition to meeting the "General Criteria" set forth under clause (d)(i) above, each Underlying Stock of a Third-Party Index shall also meet the criteria specified for Underlying Stocks of that index in the Commission's Section 19(b)(2) order approving that index or the Exchange rules under which it was approved.

(iii) *Criteria Applicable to Underlying Stocks of Issuer Indices:* In addition to meeting the "General Criteria" set forth under clause (d)(i) above, each Underlying Stock of an Issuer Index shall also meet the criteria specified in (A) or (B) below:

(A) Each Underlying Stock of an Issuer Index shall meet each of the following criteria:

(1) A minimum market value of at least \$75 million, except that for each of the lowest weighted Underlying Stocks in the index that in the aggregate account for no more than 10% of the weight of the index, the market value can be at least \$50 million;

(2) Trading volume in each of the last six months of not less than 1 million shares, except that for each of the lowest weighted Underlying Stocks in the index that in the aggregate account for no more than 10% of the weight of the index, the trading volume shall be at least 500,000 shares in each of the last six months;

(3) In a capitalization-weighted index, the lesser of the five highest weighted Underlying Stocks in the index or the highest weighted Underlying Stocks in the index that, in the aggregate, represent at least 30% of the total number of Underlying Stocks in the index, each have an average monthly trading volume of at least 2 million shares over the previous six months;

(4) 90% of the index's numerical index value and at least 80% of the total number of Underlying Stocks will meet the current criteria for standardized option trading set forth in CBOE Rule 5.3;

(5) American Depositary Receipts ("ADRs") that are not subject to comprehensive surveillance agreements do not in the aggregate represent more than 20% of the weight of the index;

(6) All component stocks or ADRs will either be listed on the American Stock Exchange or the New York Stock Exchange or traded through the facilities of the Nasdaq and reported National Market System ("NMS") securities; and

(7) No Underlying Stock will represent more than 25% of the weight of the index, and the five highest weighted Underlying Stocks in the index will not in the aggregate account for more than 50% of the weight of the index (60% for an index consisting of fewer than 25 Underlying Stocks).

(8) The standards set forth in clauses (1) to (7) above must be continuously maintained, except that:

(a) The criteria that no single Underlying Stock represent more than 25% of the weight of the index and the five highest weighted Underlying Stocks in the index cannot represent more than

<sup>8</sup> 15 U.S.C. 78s(b).

<sup>9</sup> 17 CFR 240.19b-4(e).

<sup>10</sup> 15 U.S.C. 78(s)b.

<sup>11</sup> 17 CFR 240.19b-4(e).

50% (or 60% of indices with less than 25 Underlying Stocks) of the weight of the index, need only be satisfied for capitalization-weighted and price-weighted indices as of the first day of January and July of each year;

(b) The total number of Underlying Stocks in the index may not increase or decrease by more than 33 $\frac{1}{3}$ % from the number of Underlying Stocks in the index at the time of its initial listing, and in no event may be fewer than nine Underlying Stocks;

(c) The trading volume of each Underlying Stock in the index must be at least 500,000 shares for each of the last six months, except that for each of the lowest weighted Underlying Stocks in the index that in the aggregate account for no more than 10% of the weight of the index trading volume must be at least 400,000 shares for each of the last six months; and

(d) In a capitalization-weighted index, the lesser of the five highest weighted Underlying Stocks in the index or the highest weighted Underlying Stocks in the index that in the aggregate represent at least 30% of the total number of stocks in the index have had an average monthly trading volume of at least 1 million shares over the previous six months.

(B) In the alternative, each Underlying Stock of an Issuer Index shall meet each of the following criteria:

(1)(a) A minimum market capitalization of \$3 billion and during the 12 months preceding listing is shown to have traded at least 2.5 million shares; (b) a minimum market capitalization of \$1.5 billion and during the 12 months preceding listing is shown to have traded at least 10 million shares; or (c) a minimum market capitalization of \$500 million and during the 12 months preceding listing is shown to have traded at least 15 million shares;

(2) No Underlying Stock will represent more than 25% of the weight of the index, and the five highest weighted component securities in the index do not in the aggregate account for more than 50% of the weight of the index (60% from an index consisting of fewer than 25 component securities), except that for capitalization-weighted and price-weighted indices, these standards need be satisfied only as of the first day of January and July in each year;

(3) If any Underlying Stock is the stock of a non-U.S. company that is traded in the U.S. market as sponsored American Depositary Shares ("ADS") or ADRs then for each such security the Exchange shall either:

(a) Have in place a comprehensive surveillance sharing agreement with the primary exchange on which each security underlying the ADS or ADR is traded;

(b) The combined trading volume of each non-U.S. security and other related non-U.S. securities occurring in the U.S. market or in markets with which the Exchange has in place a comprehensive surveillance sharing agreement represents (on a share equivalent basis for any ADS) at least 50% of the combined worldwide trading volume in each non-U.S. security, other related non-U.S. securities, and other classes of common stock related to each non-U.S. security over the six-month period preceding the date of listing of the related index-linked exchangeable note; or (c)(i) The combined trading volume of each non-U.S. security and other related non-U.S. securities occurring in the U.S. market represents (on a share equivalent basis) at least 20% of the combined world-wide trading volume in each non-U.S. security and in other related non-U.S. securities over the six-month period preceding the date of listing of the related index-linked exchangeable note; (ii) the average daily trading volume for each non-U.S. security in the U.S. markets over the six months preceding the date of listing of the related index-linked exchangeable note is 100,000 or more shares; and (iii) the trading volume is at least 60,000 shares per day in the U.S. markets on a majority of the trading days for the six months preceding the date of listing of the related index-linked exchangeable note.

(4) An Underlying Stock may not exceed 5% of the total outstanding common shares of the issuer of that Underlying Stock, however, if any Underlying Stock is a non-U.S. security represented by ADSs, common shares, or otherwise, then for each such index-linked exchangeable note the instrument may not exceed

(a) 2% of the total shares outstanding worldwide provided at least 20% of the worldwide trading volume in each non-U.S. security and related non-U.S. security during the six-month period preceding the date of listing occurs in the U.S. market;

(b) 3% of the total worldwide shares outstanding provided at least 50% of the worldwide trading volume in each non-U.S. security and related non-U.S. security during the six-month period preceding the date of listing occurs in the U.S. market; and

(c) 5% of the total shares outstanding worldwide provided at least 70% of the worldwide trading volume in each non-U.S. security and related non-U.S.

security during the six-month period preceding the date of listing occurs in the U.S. market.

(5) If any non-U.S. security and related securities has less than 30% of the worldwide trading volume occurring in the U.S. market during the six-month period preceding the date of listing, then the instrument may not be linked to that non-U.S. security.

If an issuer proposes to list an index-linked exchangeable note that relates to more than the allowable percentages set forth above, the Exchange with the concurrence of the staff of the Division, will evaluate the maximum percentage of index-linked exchangeable notes that may be issued on a case-by-case basis. If an Underlying Stock to which an index-linked exchangeable note is to be linked is the stock of a non-U.S. company which is traded in the U.S. market as a sponsored ADS, ordinary shares or otherwise, then the minimum number of holders of such Underlying Stock shall be 2,000.

#### *F. Exchange Rules Applicable to Index-Linked Exchangeable Notes*

Index-linked exchangeable notes will be treated as equity instruments. Index-linked exchangeable notes will be subject to all Exchange rules governing the trading of equity securities, including provisions of CBOE Rule 30.76 (Trade-Through Rule), which prohibits Exchange members from initiating trade-throughs for ITS securities, as well as Exchange rules governing priority, parity and precedence of orders, market volatility-related trading halt provisions and responsibilities of market-makers.<sup>12</sup> Exchange equity margins will apply to the trading in index-linked exchangeable notes.

Prior to the commencement of trading in index-linked exchangeable notes, the Exchange will issue a circular to members highlighting the characteristics of index-linked exchangeable notes, including, but not limited to: That the notes are subject to call by the issuer; that members must adhere to the procedures established under CBOE Rule 9.7 in the opening of new accounts; that the Exchange may consider factors such as those set forth in CBOE Rule 24.7 in exercising its discretion to halt or suspend trading; and that trading will be halted in the event that market volatility parameters set forth in CBOE Rule 6.3B have been reached.

<sup>12</sup> However, CBOE represents that if index-linked exchangeable notes are traded only in round lots (or round-lot multiples), the Exchange's rules relating to odd-lot executions will not apply.

Lastly, the Exchange's surveillance procedures for index-linked exchangeable notes will be similar to the procedures used for equity-linked term notes, index portfolio receipts trust issued receipts, and other equity non-option products traded on the CBOE and will incorporate and rely upon existing CBOE surveillance systems. The Exchange will closely monitor activity in index-linked exchangeable notes to identify and deter any potential improper trading activity in the index-linked exchangeable notes.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>13</sup> in general and furthers the objectives of Section 6(b)(5)<sup>14</sup> in particular in that it is designed to promote just and equitable principles of trade as well as to protect investors and the public interest, by increasing trading opportunities which should, in turn, increase the depth and liquidity of the marketplace.

### *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.

### *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. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference

Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CBOE-2002-29 and should be submitted by September 12, 2002.

## IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change and Amendment Nos. 1 and 2 thereto are consistent with the requirements of Section 6(b)(5) of the Act<sup>15</sup> and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission believes the Exchange's proposal to list and trade index-linked exchangeable notes will provide an instrument for investors to achieve desired investment objectives through the purchase of debt securities—index-linked exchangeable notes—exchangeable for the cash value of the Underlying Stocks of an Underlying Index.<sup>16</sup> Accordingly, the Commission finds that the Exchange's proposal will facilitate transactions in securities, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest, and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>17</sup> Furthermore, the Commission has

<sup>15</sup> 15 U.S.C. 78f(b)(5). In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>16</sup> Index-linked exchangeable notes will generally be acquired, held or transferred only in round-lot amounts (or round-lot multiples) of 100 notes although odd-lot orders are permissible. Although these notes will have features similar to other index related products, they differ from other products with respect to their exchangeability feature. The Commission notes that the holder of the note may exchange the notes at his or her option, on call by the issuer, or at maturity for the cash value based upon the reported market prices of the Underlying Stocks of an Underlying Index. Holders, however, will generally be required to exchange a certain specified minimum amount of index-linked exchangeable notes, although this minimum requirement may be waived following a downgrade in the issuer's credit rating below specified thresholds or the occurrence of other specified events.

<sup>17</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of exchange trading for new products upon a finding that the introduction of the product is in the public interest. Such a finding would be difficult with respect to a product that served no investment, hedging or other economic functions, because any benefits that might be derived by market participants would likely be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns.

approved the trading of identical products on the Amex<sup>18</sup> and the Phlx.<sup>19</sup>

The Commission notes that the initial offering price of an index-linked exchangeable note will be determined on the date that the note is priced for sale to the public. The Commission believes that index-linked exchangeable notes will be attractive to investors because they are expected to trade at lower cost than the cost of trading each of the Underlying Stocks separately. The Commission also notes that the Exchange will disseminate an estimate of the value of a note for each series of index-linked exchangeable notes, on a real time basis, every 15 seconds. The value of any Underlying Index will also be publicly available to investors on a real time basis. The CBOE, for example, has stated that to the extent there is an existing Index, it will ensure its value is publicly available, and if it is a new Index, that the CBOE would publish the value itself on a real time basis. This will ensure investors receive up-to-date information on the value of the note and the Underlying Index. Accordingly, index-linked exchangeable notes should allow investors to: (i) Respond quickly to market changes through intra-day trading opportunities; (ii) engage in hedging strategies not currently available to retail investors; and (iii) reduce transaction costs for trading a group or index of securities.

Although the value of index-linked exchangeable notes will be based on the value of the Underlying Stocks in an Underlying Index, index-linked exchangeable notes are not leveraged instruments.<sup>20</sup> In essence, index-linked exchangeable notes are debt securities based on the Underlying Stocks of an Underlying Index; the holders of such notes will not be considered owners of the Underlying Stocks and will not have the rights of a stockholder in those stocks. However, index-linked exchangeable notes will be regulated as equity instruments and will be subject to all of the Exchange's rules governing the trading of equity securities. Nevertheless, the Commission believes that the unique nature of index-linked exchangeable notes, related to, among

<sup>18</sup> See Securities Exchange Act Release No. 44621, *supra* note 3.

<sup>19</sup> See Securities Exchange Act Release No. 45082, *supra* note 3.

<sup>20</sup> In contrast, proposals to list exchange-traded derivative products that contain a built-in leverage feature or component raise additional regulatory issues, including heightened concerns regarding manipulation, market impact, and customer suitability. See, e.g., Securities Exchange Act Release No. 36165 (August 29, 1995), 60 FR 46653 (September 7, 1995) (relating to the establishment of uniform listing and trading guidelines for stock index, currency, and currency index warrants).

<sup>13</sup> 15 U.S.C. 78f(b).

<sup>14</sup> 15 U.S.C. 78f(b)(5).

other things, the exchangeability feature,<sup>21</sup> raise certain product design, disclosure, trading, and other issues that must be addressed.

#### *A. Index-Linked Exchangeable Notes Generally*

The Commission believes that the proposed index-linked exchangeable notes are reasonably designed to provide investors with an investment vehicle that substantially reflects the value of the Underlying Stocks of an Underlying Index. Index-linked exchangeable notes will be treated as equity instruments subject to CBOE rules governing the trading of equity securities. As such, the Commission finds that adequate rules and procedures exist to govern the trading of index-linked exchangeable notes. In this regard, the Commission notes that the Exchange will impose specific criteria in the selection of issuers, the Underlying Stocks, and the Underlying Indices.

As noted above, the CBOE rules for index-linked exchangeable notes contain specific criteria for issuers. For example, the issuer must have a minimum tangible net worth in excess of \$250 million and substantially exceed the earnings requirements in the first sentence of CBOE Rule 31.5(A)(2); or a minimum tangible value of \$150 million, substantially exceed the earnings requirements in the first sentence of CBOE Rule 31.5(A)(2), and not to have issued index-linked exchangeable notes where the original issue price of all the issuer's other index-linked exchangeable note offerings (combined with other index-linked exchangeable note offerings of the issuer's affiliates) listed on a national securities exchange or traded through the facilities of Nasdaq exceeds 25% of the issuer's net worth. These criteria are in part intended to ensure that the issuer has enough assets to meet its obligations under the terms of the note and should help to reduce systematic risk.

The minimum issue requirements for the issue of index-linked exchangeable notes should also serve to establish a minimum level of liquidity for the product. These issue requirements include: (i) A minimum public distribution of 150,000 notes with a minimum of 400 public noteholders (no minimum number of holders if traded in one thousand dollar denominations), and (ii) market value of \$4 million.

The CBOE rules applicable to the index-linked exchangeable notes also contain minimum requirements for the

Indices the note can be linked to and the underlying components of those Indices. For example, because all components of an Underlying Index must be a U.S. reporting company, there will be information of available Index component stocks. Further, the CBOE's proposed rules for the Indices underlying index-linked exchangeable notes are linked to other approved criteria for index related products. Accordingly, any Underlying Index would have to follow the criteria adopted by the Commission for that Index, including the criteria for component stocks already in CBOE's rules. These requirements will generally contain, among other things, minimum market capitalization, trading volume, and concentration requirements that are designed to reduce manipulation concerns and ensure a minimum level of liquidity for component securities.

In summary, the rules for selecting components of Indices are intended to make the Underlying Stocks and the Underlying Indices representative of the market they are intended to reflect as well as to reduce manipulation concerns by setting forth minimum liquidity standards for Underlying Stocks. Accordingly, the Commission believes that these criteria should serve to ensure that the Underlying Stocks of Underlying Indices are well capitalized and actively traded.

#### *B. Disclosure*

The Commission believes that the Exchange's proposal should ensure that investors have information that will allow them to be adequately apprised of the terms, characteristics, and risks of trading index-linked exchangeable notes. The Commission notes that upon the initial listing of any class of index-linked exchangeable notes, the Exchange will issue a circular to its members explaining the unique characteristics and risks of this type of security.<sup>22</sup> The circular will also note Exchange members' responsibilities under CBOE Rule 30.50(c) regarding transactions in index-linked exchangeable notes. CBOE Rule 30.50(c) generally requires that members use due diligence to learn the essential facts relative to every customer, every order or account accepted.<sup>23</sup> Exchange Rule 30.50(c) further requires that members be personally informed of the essential facts of each customer prior to giving

the required written approval for the opening of that customer account.<sup>24</sup>

#### *C. Trading of Index-Linked Exchangeable Notes*

The Commission finds that adequate rules and procedures exist to govern the trading of index-linked exchangeable notes. Index-linked exchangeable notes will be treated as equity instruments subject to all CBOE rules governing the trading of equity securities. These rules include: rules governing priority, parity and precedence of orders, market volatility related trading halt provisions pursuant to Exchange Rule 6.3B, responsibilities of specialists, members dealing for their own accounts, odd-lot brokers, and registered traders, and handling of orders and reports. In addition, the Exchange's equity margin rules and the regular equity trading hours of 9:30 am to 4:00 pm will apply to transactions in index-linked exchangeable notes.

The Commission is satisfied with CBOE's development of specific listing and delisting criteria for index-linked exchangeable notes. For example, in connection with the initial listing of each series of index-linked exchangeable notes, the Exchange has established that a minimum of 150,000 notes held by at least 400 holders be required to be outstanding when trading begins. These criteria should help ensure that a minimum level of liquidity will exist in each series of index-linked exchangeable notes to allow for maintenance of fair and orderly markets. The delisting criteria also allows the Exchange to consider suspension of trading and the delisting of a series of index-linked exchangeable notes if an event were to occur that made further dealings in such series inadvisable. This will give the CBOE flexibility to delist index-linked exchangeable notes if circumstances warrant such action. Further, CBOE rules have specific criteria that allow them to delist if there is fewer than 50,000 notes issued and outstanding, or if the market value of the index-exchangeable notes is less than \$100,000. This should ensure a minimum level of liquidity for these products. Accordingly, the Commission believes that the rules governing the trading of index-linked exchangeable notes, consistent with Section 6(b)(5) of the Act,<sup>25</sup> provide adequate safeguards to protect investors and the public interest. While the index-linked exchangeable notes have certain call and redemption features that make them different from other products, the CBOE

<sup>22</sup> The Exchange represents that it will highlight the exchangeability feature of index-linked exchangeable notes in its circular to members.

<sup>23</sup> CBOE Rule 30.50(c).

<sup>24</sup> *Id.*

<sup>25</sup> 15 U.S.C. 78f(6)(5).

<sup>21</sup> See *supra* note 15.

has addressed any concerns by adopting the existing criteria used in other index related products. In addition, the CBOE will highlight these different features in the circular to members.

#### D. Dissemination of Information

The Commission believes that the value of index-linked exchangeable notes that the Exchange proposes to disseminate will provide investors with timely and useful information concerning the value of the index-linked exchangeable notes based on current information regarding the value of the Underlying Index. The value of the Underlying Index will also be publicly disseminated. This information will be disseminated and updated every 15 seconds during regular CBOE trading hours of 8:30 a.m. to 3 p.m., Chicago time.

#### E. Surveillance

The Commission believes that the surveillance procedures developed by the CBOE for index-linked exchangeable notes should be adequate to address concerns associated with the listing and trading of such notes. In this regard, the CBOE has developed procedures to monitor activity in index-linked exchangeable notes to identify and deter improper trading activity.

The Commission also notes that concerns are raised when a broker-dealer is involved in the development and maintenance of an Underlying Index upon which a product, such as index-linked exchangeable notes is based, in that case, the broker-dealer and its affiliate should have procedures designed specifically to address the improper sharing of information. The Commission notes that the Exchange requires the implementation of procedures that are satisfactory to the Exchange to prevent the misuse of material, non-public information regarding changes to Underlying Stocks of an Underlying Index in a particular series of index-linked exchangeable notes. In addition, the Commission notes that if a broker-dealer is involved in developing or maintaining an Underlying Index, the Index must be calculated by a third party who is not a broker-dealer.<sup>26</sup> The Commission believes that such information barrier procedures will address the unauthorized transfer and misuse of material, non-public information.

#### F. Scope of the Commission's Order

The Commission is approving the Exchange's proposed listing and trading standards for the index-linked

exchangeable notes as discussed herein. Index-linked exchangeable notes addressed in this order can be listed pursuant to Rule 19b-4(e)<sup>27</sup> if they meet the standards discussed above in the CBOE rules. The Commission notes that with respect to any future rules adopted by the Exchange pursuant to Rule 19b-4(e),<sup>28</sup> the Exchange has indicated that in its Section 19(b)(2) filings to adopt such new rules, it will state and discuss whether or not it proposes to apply the new rule standards to index-linked exchangeable notes.

#### G. Accelerated Approval

The Commission finds good cause for approving the proposal and Amendments Nos. 1 and 2 thereto prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The proposal establishes listing and trading standards for a new product, index-linked exchangeable notes. Granting accelerated approval will allow the Exchange to immediately begin listing and trading series of index-linked exchangeable notes under these new standards. While the structure of the product is different from those previously reviewed by the Commission, the CBOE proposes to apply existing criteria used for other index related products. In addition, the Commission has approved the trading of identical products on the Amex<sup>29</sup> and the Phlx.<sup>30</sup> Accordingly, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b) of the Act,<sup>31</sup> to approve the proposal and Amendments Nos. 1 and 2 thereto on an accelerated basis.

#### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>32</sup> that the proposed rule change (SR-CBOE-2002-29) and Amendments Nos. 1 and 2 thereto are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>33</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 02-21377 Filed 8-21-02; 8:45 am]

**BILLING CODE 8010-01-P**

<sup>27</sup> 17 CFR 240.19b-4(e).

<sup>28</sup> 17 CFR 240.19b-4(e).

<sup>29</sup> See Securities Exchange Act Release No. 44621, *supra* note 3.

<sup>30</sup> See Securities Exchange Act Release No. 45082, *supra* note 3.

<sup>31</sup> 15 U.S.C. 78f(b)(5) and 78s(b).

<sup>32</sup> 15 U.S.C. 78s(b)(2).

<sup>33</sup> 17 CFR 200.30-3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46369; File No. SR-NASD-2002-42]

### Self-Regulatory Organizations; Order Granting Approval to a Proposed Rule Change and Amendments Nos. 1, 2, 3, 4, 5 and 6 Thereto by the National Association of Securities Dealers, Inc. Relating to the Integrated Processing of Odd-Lot Share Amounts in Nasdaq's SuperMontage System

August 16, 2002.

#### I. Introduction

On March 25, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend several NASD Rules governing the operation of Nasdaq's future Order Display and Collector Facility ("SuperMontage") to allow the system to accept, integrate, process, and otherwise facilitate the interaction of orders of less than one round-lot (100 shares) with all other SuperMontage quotes and orders. Nasdaq filed Amendment No. 1 to the proposed rule change on April 23, 2002.<sup>3</sup> Nasdaq filed Amendment No. 2 to the proposed rule change on May 17, 2002.<sup>4</sup> Nasdaq filed Amendment No. 3 to the proposed rule change on May 17, 2002.<sup>5</sup> The proposed rule change, as amended by Amendments Nos. 1, 2, and 3, was published for comment in the **Federal Register** on May 28, 2002.<sup>6</sup> The Commission received thirteen comment letters on the proposed rule change, as amended.<sup>7</sup> Nasdaq filed Amendment

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> On April 23, 2002, the Exchange filed a Form 19b-4, which replaced the original filing in its entirety ("Amendment No. 1").

<sup>4</sup> On May 17, 2002, the Exchange filed a Form 19b-4, which replaced the original filing and Amendment No. 1 in their entirety ("Amendment No. 2").

<sup>5</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated May 17, 2002 ("Amendment No. 3").

<sup>6</sup> See Securities Exchange Act Release No. 45968 (May 20, 2002), 67 FR 36946 ("Proposing Release").

<sup>7</sup> See email to rule-comments@sec.gov, Commission, from Joshua Levine, dated May 30, 2002 ("Levine Letter"). See also letters to Jonathan G. Katz, Secretary, Commission, from Keith A. Gertsen, Managing Director, Head, Nasdaq Trading,

Continued

<sup>26</sup> See CBOE Rule 24.2(b)(12).