

Companies, as appropriate, shall take such steps as may be necessary to comply with rules 6e-2 and 6e-3(T), or rule 6e-3, as such rules are applicable.

11. The Participants, at least annually, will submit to the Board such reports, materials, or data as a Board reasonably may request so that the trustees of the Board may fully carry out the obligations imposed upon the Board by the conditions contained in this application. Such reports, materials, and data will be submitted more frequently if deemed appropriate by the Board. The obligations of the Participants to provide these reports, materials, and data to the Board, when it so reasonably requests, will be a contractual obligation of all Participants under their agreements governing participation in the Portfolios.

12. All reports of potential or existing conflicts received by the Board, and all Board action with regard to determining the existence of a conflict, notifying Participants of a conflict, and determining whether any proposed action adequately remedies a conflict, will be properly recorded in the minutes of the Board or other appropriate records, and such minutes or other records shall be made available to the Commission upon request.

13. The Trust will not accept a purchase order from a Qualified Plan if such purchase would make the Qualified Plan shareholder an owner of 10 percent or more of the assets of such Portfolio unless such Qualified Plan executes an agreement with the Trust governing participation in such Portfolio that includes the conditions set forth herein to the extent applicable. A Qualified Plan or Qualified Plan participant will execute an application containing an acknowledgment of this condition at the time of its initial purchase of shares of any Portfolio.

## Conclusion

Applicants submit, based on the grounds summarized above, that the exemptions requested are necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 03-4503 Filed 2-25-03; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-25939; File No. 812-12370]

### The Lincoln National Life Insurance Company, *et al.*; Notice of Application

February 20, 2003.

**AGENCY:** Securities and Exchange Commission (the "Commission").

**ACTION:** Notice of Application for an order pursuant to Section 11(a) of the Investment Company Act of 1940 (the "Act") approving the terms of an offering of an enhancement offer.

*Applicants:* The Lincoln National Life Insurance Company ("Lincoln Life"), Lincoln National Variable Annuity Account E ("Account E"), Lincoln National Variable Annuity Account H ("Account H") (Account E and Account H collectively, "Annuity Accounts") and American Funds Distributors, Inc. ("AFD").

*Summary of Application.* Applicants seek an order approving the terms of a proposed offering of an enhancement offer for certain contracts issued and outstanding whereby an enhancement benefit would be added to the contracts.

*Filing Date.* The application was filed on December 19, 2000 and amended and restated on December 31, 2001 and on February 10, 2003.

*Hearing or Notification of Hearing.* An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Secretary of the Commission and serving Applicants with a copy of the request, personally or by mail. Hearing requests must be received by the Commission by 5:30 p.m. on March 17, 2003, and should be accompanied by proof of service on Applicants in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the requester's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Secretary of the Commission.

**ADDRESSES:** Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Applicants, Mary Jo Ardington, Esq., The Lincoln National Life Insurance Company, 1300 S. Clinton Street, PO Box 1110, Fort Wayne, IN 46801-1110.

#### FOR FURTHER INFORMATION CONTACT:

Lorna MacLeod, Branch Chief, or Rebecca Marquigny, Senior Attorney, Office of Insurance Products, Division of Investment Management, at (202) 942-0670.

**SUPPLEMENTARY INFORMATION:** The following is a summary of the application. The complete application is available for a fee from the Public Reference Branch of the Commission, 450 Fifth Street, NW, Washington, DC 20549-0102, (202) 942-8090.

### Applicants' Representations

1. Lincoln Life was founded in 1905 under Indiana Law, and is a wholly-owned subsidiary of Lincoln National Corp., which is organized under Indiana law. Lincoln National Corp.'s primary businesses are insurance and financial services. Lincoln Life is the Annuity Accounts' depositor within the meaning of the Act.

2. Account E was established on September 26, 1986 and Account H was established on February 7, 1989 as insurance company separate accounts under Indiana law. They are registered with the Commission as unit investment trusts under the provisions of the Act. The Annuity Accounts are segregated investment accounts and as such their assets may not be charged with liabilities resulting from any other business that Lincoln Life may conduct. Income, gains and losses, whether realized or not, from assets allocated to the Annuity Accounts are, in accordance with the applicable annuity contracts, credited to or charged against the Annuity Accounts, and without regard to any other income, gains or losses of Lincoln Life. The Annuity Accounts satisfy the definition of a separate account under the federal securities law. The Annuity Accounts are registered on Form N-4 under the Act as unit investment trusts.

3. The Annuity Accounts fund the American Legacy Series of Variable Annuity Contracts ("Legacy Contracts") that Lincoln Life and AFD have offered and sold for a number of years including the American Legacy Contract ("Legacy I") and the American Legacy II Contract ("Legacy II"). The contracts are flexible premium deferred variable and fixed annuity contracts under which contract owners may pay one or more purchase payments over a period of time.

4. The subaccounts are invested in funds of the American Funds Insurance Series. To the extent that an owner selects one or more subaccounts, his or her investment in the contract will vary with the investment performance of the selected subaccount. To the extent that an owner selects the general account, Lincoln Life guarantees that the amount allocated to the general account will be credited with a minimum interest rate and Lincoln Life may credit additional interest which it may declare from time to time.

5. AFD is the distributor and primary underwriter of the contracts issued by Lincoln Life through the Annuity Accounts. AFD is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of the National Association of Securities Dealers.

6. The Application relates to two Legacy Contracts. The Legacy I contracts issued through Account E have been registered under the Securities Act of 1933 pursuant to a registration statement on Form N-4. The Legacy II contracts issued through Account H have been registered under the Securities Act of 1933 pursuant to a registration statement on Form N-4.

7. During the accumulation period under the Legacy Contracts, based upon the contract owner's instructions, purchase payments are allocated to the selected subaccounts of the Annuity Accounts and/or Lincoln Life's general account. To the extent that an owner selects one or more subaccounts, his or her investment in the contract will vary with the investment performance of the selected subaccount(s).

8. A contract owner can elect to receive annuity payments under his or her contract. Under a contract, annuity payments are based upon the life of an annuitant and in some cases the lives of two (or joint) annuitants. Annuity options are available on a variable basis (*i.e.*, funded by the Annuity Accounts) and/or on a fixed basis (*i.e.*, funded through Lincoln Life's general account).

9. The Legacy I contract has been offered and sold for a number of years. The minimum purchase payment for Legacy I is \$1500 for nonqualified contracts and \$300 for qualified contracts. Legacy I contracts impose a surrender charge of up to 6% of any amount by which purchase payments withdrawn in any year exceed 10% of purchase payments (however, this 10% withdrawal exception does not apply to a surrender of a contract). The surrender charge associated with each purchase payment after year 2 declines 1% each year until it is 0% at the end of the seventh year after the payment was made.

10. The Legacy I contracts also impose the following charges: (a) a daily mortality and expense risk charge at an annual rate of 1.25% of the daily net asset value of Account E; (b) for contracts that include the Enhanced Guaranteed Minimum Death Benefit ("EGMDB"), an additional daily charge at an annual rate of 0.15% of the net asset value of Account E; (c) an annual contract maintenance charge of \$35; and (d) a charge corresponding to any

applicable state premium tax or other tax levied by any governmental entity.

11. The Legacy II contracts impose a minimum purchase payment of \$1500 for nonqualified contracts and \$300 for qualified contracts. The Legacy II contracts also impose a surrender charge of up to 6% of any amount by which purchase payments withdrawn in any year exceed 10% of purchase payments (however, this 10% withdrawal exception does not apply to a surrender of a contract). The surrender charge associated with each purchase payment after year 2 declines 1% each year until it is 0% at the end of the seventh year after the payment was made.

12. The Legacy II contracts also impose the following charges: (a) a daily mortality and expense risk charge at an annual rate of 1.25% of the daily net asset value of Account H; (b) a daily administrative charge at an annual rate of 0.10% of the daily net asset value of Account H; (c) for those contracts that include the EGMDDB, a daily charge at an annual rate of 0.15% of the net asset value of Account H; (d) an annual contract maintenance charge of \$35; and (e) a charge corresponding to any applicable state premium tax or other tax levied by any governmental entity.

13. Under both the Legacy I and Legacy II contracts, the death benefit equals the greater of: (a) the Guaranteed Minimum Death Benefit ("GMDB"), or if elected, the EGMDDB, or (b) the current value of the contract as of the day Lincoln Life approves the claim for payment. For these contracts, the GMDB is equal to

- a. The sum of all purchase payments, plus
- b. any gain attributable to those purchase payments as of the seventh anniversary date of each payment, minus
- c. any withdrawals.

The attributable gain consists of the earnings on each contract years' net purchase payments (purchase payments minus any withdrawals) as of the valuation date just before the seventh anniversary of the purchase payment (*i.e.* once the surrender charge period for the purchase payment has expired). For the GMDB to apply, the annuitant, as of the seventh anniversary of each eligible contract year, must still be living and must be less than 81 years of age.

14. For Legacy I and Legacy II, the EGMDDB is an alternative to the GMDB for nonqualified contracts or contracts used under an IRA plan. Under the EGMDDB, the death benefit payable is the amount equal to the greatest of:

- a. Contract value as of the day on which Lincoln Life approves the payment of the claim; or

- b. the sum of all purchase payments less the sum of all withdrawals, partial annuitizations and premium taxes incurred; or

- c. the highest contract value determined as follows:

- (i) When the first of the annuitant, sole contract owner or, in the event the contract is owned by more than one person, the named contract owner or pre-designated joint owner dies, we determine the highest contract value;

- (ii) this highest contract value is as of any contract anniversary from the time the EGMDDB takes effect up to and including the decedent's age 80;

- (iii) this highest contract value is then increased by purchase payments and decreased by partial withdrawals, partial annuitizations and premium taxes made, effected or incurred subsequent to the anniversary date on which the highest contract value is attained.

15. If the Legacy I or Legacy II contract has more than one joint owner, the GMDB or EGMDDB death benefit will only be paid on the death of the named contract owner or pre-designated joint owner. If the contract owner does not make this pre-designation, the youngest joint owner will be the pre-designated joint owner. Only the cash surrender values will be paid upon the death of a non-pre-designated joint owner. If there are two or more joint owners, the surrender charge is waived only on the death of the named contract owner or pre-designated joint owner.

16. Lincoln Life now proposes to offer an enhancement option ("Enhancement Offer") to Legacy I and Legacy II contract owners whose contracts have surrender charges equal to 2% or less of their contract value. The Enhancement Offer consists of two options (collectively the "Offers"): (a) an immediate bonus credit equal to 2% of contract value ("Bonus Offer"); or (b) an EGMDDB at no additional cost ("EGMDDB Offer"). An owner can elect only one of the options.

17. The existing contract will remain in place. However, in exchange for the selected enhancement option the entire contract value (excluding any bonus credit, if that option was selected) will be subject to new surrender charges as of the date the option is accepted. For purposes of calculating surrender charges, the contract value (excluding the bonus credit) will be treated as a new purchase payment. Any remaining surrender charges existing prior to the time of the election of the option will be waived.

18. The offer is only available for contracts sold in the nonqualified and IRA markets (excluding SEP or SARSEP markets), and this offer is not available for those contracts in which the primary

owner, pre-designated joint owner, or annuitant is over age 76.

19. For contract owners who elect the Bonus Offer or the EGMDDB Offer, there will be no additional charges or any increase in existing charges other than the imposition of the new surrender charge.

20. Contract owners who elect the EGMDDB Offer receive the EGMDDB at no additional cost on the date the Offer is accepted. If the contract owner had previously elected the EGMDDB when he or she purchased the contract (or when the EGMDDB became available in his or her state) and is thus paying for the EGMDDB, under the EGMDDB Offer, if elected, the 0.15% charge for the EGMDDB will be discontinued as of the date the Offer is accepted, and the death benefit at all times after the enhancement will in no event be less than the death benefit that would have been payable if the Enhancement Offer had not been accepted.

21. Contract owners may cancel the elected option for any reason within ten days (in some states longer) of the date the rider adding the option was received. Upon cancellation, Lincoln Life will waive the new surrender charge and re-establish the prior existing surrender charges, if any, as of the date of the receipt of the cancellation. The contract owner assumes the investment risk on the contract value during this period. If the Bonus Offer is cancelled according to the Right to Examine provision, the bonus credits will be revoked; however, Lincoln Life will assume the risk of investment loss on the bonus credits. Lincoln Life will also re-credit the mortality and expense risk and administrative charges proportionately attributable to the bonus credits. The contract owner will be put back into the same position as if he or she had never elected the Bonus Offer. Lincoln Life will recapture the bonus credit only upon the exercise of the free look privilege.

22. Regarding the implementation of the Offers, Lincoln proposes to make the offers directly, by providing eligible contract owners with information about the offers through an "Offering Document" sent from the Home Office. Contract owners will be directed to Lincoln Life or their registered representatives for further information. Contract owners who express an interest in the Offers will be given a prospectus.

23. Registered representatives who are responsible for a contract owner accepting the Bonus Offer or the EGMDDB Offer will be paid a commission. The commission is less than what the registered representative

would receive on the sale of a new Legacy contract.

24. The Offering Document will advise such contract owners that the Offers have been designed for those contract owners who intend to continue to hold their contracts as long-term investments. An explanation of the terms of each offer will be provided. The Offering Document will state that the offers are not intended for all contract owners, and that they are especially not appropriate for any contract owner who anticipates surrendering more than a portion of his or her contract in excess of the free withdrawal amount (greater of 10% of the contract value or 10% of purchase payments) within the surrender charge period. In this regard, the Offering Document will encourage contract owners to carefully evaluate their personal financial situation when deciding whether to accept or reject the Offers. In addition, the Offering Document will explain how a contract owner who elects to participate in one of the offers may avoid the applicable surrender charge if no more than the annual free withdrawal amount (10% of purchase payments) is surrendered and any subsequent purchase payments are maintained until the expiration of the applicable surrender charge period. In this regard, the Offering Document will state in clear plain English that if the amended contract is surrendered during the new surrender charge period: (a) The contract owner will pay surrender charges which may be substantial, that he or she would not have paid if the offer had not been accepted; and (b) a contract owner may be worse off than if he or she had rejected the offer. The Offering Document also will state that if the contract is owned by three or more persons and an owner who is not the named contract owner or a pre-designated joint owner dies during the new surrender period, the remaining contract owners could be worse off having accepted the Enhancement Offer because a new surrender charge will apply.

#### Applicants' Legal Analysis

1. The purpose of Section 11 is to prevent the practice of inducing exchanges solely for the purpose of exacting additional selling charges. While the sales representatives will receive a commission and there will be imposed a surrender charge, Applicants argue that based on the foregoing, one should readily conclude that the sole purpose of the Offer is not to exact selling charges but to offer significant benefits to the contract owners as

inducement for them to remain contract owners of Lincoln Life.

2. Section 11(a) of the Act makes it unlawful for any registered open-end company, or any principal underwriter for such company, to make or cause to be made an offer to the holder of a security of such company, or of any other open-end investment company to exchange his security for a security in the same or another such company on any basis other than the relative net asset values of the respective securities to be exchanged, unless the terms of the offer have first been submitted to and approved by the Commission or are in accordance with Commission rules adopted under Section 11.

3. Section 11(c) of the Act, in pertinent part, requires, in effect, that any offer of exchange of the securities of a registered unit investment trust for the securities of any other investment company be approved by the Commission or satisfy applicable rules adopted under Section 11, regardless of the basis of the exchange.

4. The Annuity Accounts are registered under the Act as unit investment trusts. Thus, the exchange offer constitutes an offer of exchange of two securities, each of which is offered by a registered unit investment trust. While Applicants would argue that the enhancement offer on its face is not subject to Section 11 because it does not involve the offer of exchange of two securities, nonetheless, it would appear that it is the Commission's current position that offers such as the Enhancement Offer do fall within the ambit of Section 11.

5. According to the Commission, Congress enacted Section 11 to prevent "switching," *i.e.*, "the practice of inducing security holders of one investment company to exchange their securities for those of a different investment company solely for the purpose of exacting additional selling charges." According to the Commission, "[I]nvestors in 'fixed trusts,' now known as unit investment trusts ('UIT'), were found to be particularly vulnerable to switching operations. In order to earn another sales commission, a UIT sponsor would often pressure unit holders into exchanging their units for those of another of the sponsor's trusts."

6. Section 11(c) of the Act requires Commission approval (by order or by rule) of any exchange, regardless of its basis, involving securities issued by a unit investment trust because investors in unit investment trusts were found by Congress to be particularly vulnerable to switching transactions. Applicants believe that the potential for harm to investors perceived in switching by

Congress was its use to extract additional sales charges from those investors.

7. As opposed to providing a means of extracting additional sales charges, as contemplated by the prohibitions of Section 11, Applicants argue that the proposed Offers provide enduring benefits to the contract owners. To the extent that a contract owner ultimately did not benefit from accepting the offer, it would be as a result of his or her own subsequent decision to surrender the enhanced contract in circumstances that would have been the subject of very explicit disclosure. If the contract is owned by three or more persons an owner who is not the named contract owner or a pre-designated joint owner dies during the new surrender charge period, the remaining contract owners also could be worse off having accepted the Enhancement Offer because the new CDSC will apply. This disclosure provided in the offering materials will give contract owners sufficient information to determine what is best for them.

8. Rule 11a-2, by its express terms, provides for Commission approval of certain types of offers of exchange of one variable annuity contract for another. Other than the relative net asset value requirement for the Bonus Offer, the only part of Rule 11a-2 that would not be satisfied by the proposed Offers is the requirement that payments under the existing Legacy contracts be treated as if they had been made under the enhanced contracts on the dates actually made. This provision of Rule 11a-2 is often referred to as a "tacking" requirement because it has the effecting of "tacking together" the CDSC expiration periods of the exchanged and acquired contracts.

9. Applicants believe that tacking should be viewed as a useful way to avoid the need to scrutinize the terms of an offer of exchange to make sure that there is no abuse. Tacking is not a requirement of Section 11. Rather, it is a creation of a rule designed to approve the terms of offers of exchange "sight unseen." Tacking focuses on the closest thing to multiple deduction of sales loads that is possible in a CDSC contract—multiple exposure to sales loads upon surrender or redemption. If tacking and other safeguards of Rule 11a-2 are present, there is no need for the Commission or its staff to evaluate the terms of the offer. The absence of tacking in this fully scrutinized Section 11 application will have no import in offers made pursuant to the rule on a "sight unseen" basis.

10. In addition to providing extensive disclosure, the Offers will only be made

to contract owners who are at or close to the expiration of their surrender charge period.

11. No tacking is required when Lincoln Life's competitors offer their variable annuity contracts to owners of the Legacy I and Legacy II contracts or indeed when Lincoln makes such an offer to competitors' contract owners. In those exchanges, unlike the Offers proposed here, the exchanging contract owner actually must pay any remaining CDSC on the exchanged contract at the time of the exchange. The broker/dealers that will be making recommendations to their customers regarding these offers are required to satisfy the suitability requirements. Therefore, while tacking is not present, the investor protection afforded by the suitability requirements imposed upon the broker/dealer and the additional disclosure will be. The contract owner who is fully informed of the advantages and disadvantages of the proposed offers is the person who knows best whether the benefits of the offer are appropriate for him or her.

12. By this Application, Applicants are seeking a "level playing field" to permit Lincoln to compete with offers of competitors to its longstanding contract owners. Absent the requested relief, there can be no such offers, as imposition of the Rule 11a-2 tacking requirement would make it unfeasible for the offers to be made. Applicants assert that approval of the terms of the Offers is warranted, among other reasons, because it will promote competition in the variable annuity marketplace. Such approval will foster competition by allowing Lincoln Life to make an offer to its own contract owners which would provide an attractive additional option for contract owners' consideration. Applicants argue that the Offers do not remove choices available; rather competition is increased if Lincoln Life is able to compete on a "level playing field" with its competitors.

#### Applicants' Conditions

If the requested order is granted, Applicants consent to the following conditions, which are intended to support the understanding that the Offers are being made to contract owners who expect to persist:

1. The Offering Document will contain, as relevant, concise, plain English statements that:

(a) The Enhancement Offer is suitable only for contract owners who expect to hold their contracts as long term investments; and

(b)(i) if a contract owner surrenders contract value over and above the free

withdrawal amount before the expiration of the new surrender charge period that applies to the contract value as of the date the Enhancement Offer is accepted, the contract owner will pay surrender charges, which may be substantial, that he or she would not have paid had the offer not been accepted;

(ii) if the contract is owned by three or more persons and an owner who is not the named contract owner or a pre-designated joint owner dies during the new surrender charge period, the remaining contract owners could be worse off having accepted the Enhancement Offer because a new surrender charge will apply; and

(iii) the contract owner may be worse off than if he or she had rejected the Enhancement Offer.

2. Lincoln Life will send the Offering Document directly to eligible contract owners. A contract owner choosing either the Bonus Offer or the EGMDDB Offer will then complete and sign an election form which will prominently restate in concise, plain English the statements required in Condition No. 1, and will return it to Lincoln Life. If the election form or the internal exchange form is more than two pages long, Lincoln Life will use a separate document to obtain the contract owner's acknowledgment of the statements referred to in Condition No. 1.

3. Lincoln Life will maintain the following separately identifiable records in an easily accessible place, for the time periods specified below in this Condition 3 for review by the Commission upon request:

(a) Records showing the level of acceptances of the Enhancement Offer and how these acceptances relate to the total number of contract owners eligible to participate in the offer (quarterly as a percentage of the number eligible);

(b) copies of any form of Offering Document, and any other written materials or scripts for presentations by representatives regarding the Enhancement Offer that Lincoln Life either prepares or approves, including the dates that such Offering Document and materials were used;

(c) records containing information about each Enhancement Offer election that occurs, including the name of the contract owner; the old and new contract numbers; the amount of CDSC waived on the transaction; bonus credit paid; if the EGMDDB is elected or the EGMDDB fee is waived; the name and CRD number of the registered representative soliciting the Enhancement Offer, firm affiliation, branch office address and telephone number of the registered representative

soliciting the Enhancement Offer; the name and CRD number of the registered representative's broker-dealer; commission paid; the election form (and separate document, if any, used to obtain the contract owner's acknowledgment of the statements required in Condition No. 1) showing the name, date of birth, address and telephone number of the contract owner and the date the election form (or separate document) was signed; amount of contract value at the time of election of the Enhancement Offer; and persistency information relating to the enhanced contract, including the date of any subsequent surrender and the amount of CDSC paid on the surrender; and

(d) logs showing a record of any contract owner complaint about the Enhancement Offer; state insurance department inquiries about the Enhancement Offer; or litigation, arbitration or other proceedings regarding any enhanced contract. The logs will include the date of the complaint or commencement of the proceeding, name and address of the person making the complaint or commencing the proceeding, nature of the complaint or proceeding, and the persons named or involved in the complaint or proceeding.

Applicants will retain records specified in (a) and (d) for a period of six years after the date the records are created; records specified in (b) for a period of six years after the date of last use; and records specified in (c) for a period of two years after the date that the CDSC period of the Enhanced Contract ends with respect to contract value as of the date the Enhancement Offer is accepted.

4. The Offering Document will disclose in concise plain English each aspect of the enhanced contracts that will be less favorable than the old contracts.

## Conclusion

For all the reasons discussed above, Applicants submit (1) that the Offers provide additional benefits to contract owners, may be advantageous for the owners to whom they will be offered, and do not contravene any policy or purpose of Section 11, and (2) that approval of Applicants' Offers as described, and subject to the conditions set forth in this Application, is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Act. Therefore, Applicants submit that the Commission should grant the approval sought by this Application.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 03-4506 Filed 2-25-03; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47372; File No. SR-CHX-2003-02]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Stock Exchange, Incorporated to Reinstate and Extend a Pilot Rule Interpretation Relating to Trading of Nasdaq/NM Securities in Subpenny Increments

February 14, 2003.

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> notice is hereby given that on January 30, 2003, the Chicago Stock Exchange, Incorporated ("CHX" 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. The Exchange filed the proposal pursuant to Section 19(b)(3)(A) of the Act,<sup>3</sup> and Rule 19b-4(f)(6)<sup>4</sup> thereunder, 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

The Exchange proposes to extend through May 31, 2003, the pilot rule interpretation relating to the trading of Nasdaq/NM securities in subpenny increments. The CHX does not propose to make any substantive or typographical changes to the pilot; the only change is to extend the pilot's expiration date through May 31, 2003. The text of the proposal is available at the Commission and at the CHX.

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6). The Commission waived the 5-day pre-filing notice requirement.

#### 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 CHX included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The CHX 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

On April 6, 2001, the Commission approved, on a pilot basis through July 9, 2001, a pilot rule interpretation (CHX Article XXX, Rule 2, Interpretation and Policy .06 "Trading in Nasdaq/NM Securities in Subpenny Increments")<sup>5</sup> that requires a CHX specialist (including a market maker who holds customer limit orders) to better the price of a customer limit order in his book which is priced at the national best bid or offer by at least one penny if the specialist determines to trade with an incoming market or marketable limit order. The pilot has been extended five times and is set to expire on January 31, 2003.<sup>6</sup> The CHX now proposes to extend the pilot through May 31, 2003. The CHX proposes no other changes to the pilot, other than extending it through May 31, 2003.

###### 2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b).<sup>7</sup> In particular, the CHX believes the proposal is consistent with

<sup>5</sup> See Securities Exchange Act Release No. 44164 (April 6, 2001), 66 FR 19263 (April 13, 2001) (SR-CHX-2001-07).

<sup>6</sup> See Securities Exchange Act Release Nos. 44535 (July 10, 2001), 66 FR 37251 (July 17, 2001) (extending the pilot through November 5, 2001); 45062 (November 15, 2001), 66 FR 58758 (November 23, 2001) (extending the pilot through January 14, 2002); 45386 (February 1, 2002), 67 FR 6062 (February 8, 2002) (extending the pilot through April 15, 2002); 45755 (April 15, 2002), 67 FR 19607 (April 22, 2002) (extending the pilot through September 30, 2002); and 46587 (October 2, 2002), 67 FR 63180 (October 10, 2002) (extending the pilot through January 31, 2003).

<sup>7</sup> 15 U.S.C. 78f(b).