thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by September 28, 1995.

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,[45] that the proposed rule change (SR–Amex–94–38) is approved, as amended, with the portion of the rule change relating to spread margin treatment being approved on a one year pilot program basis ending August 29, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[46]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95– 22107 Filed 9–6–95; 8:45 am]

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[Release No. 34–36169; File No. SR–CBOE–94–34]

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1, 2, 3, 4 and 5 to Proposed Rule Change Relating to the Establishment of Uniform Listing and Trading Guidelines for Stock Index, Currency and Currency Index Warrants

August 29, 1995.

I. Introduction

On September 29, 1994, the Chicago Board Options Exchange, Inc. (''CBOE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to establish uniform rules for the listing and trading of broad-based stock index (''stock index'' or ''index''), currency (''currency'') and currency index (''currency index'') warrants (collectively ''warrants''). Notice of the proposed rule change appeared in the **Federal Register** on January 9, 1995.[3] One comment letter was received in response to the proposal.[4]

The Exchange subsequently filed five Amendments to the proposal. Amendment No. 1 (''Amendment No. 1'') brought several of CBOE's proposed rules and policies into conformity with those previously filed by other markets.[5] Amendment No. 2 (''Amendment No. 2'') imposes a reporting requirement for positions in currency and currency index warrants.[6] Amendment No. 3 (''Amendment No. 3'') addresses issues relating to settlement methodology, surveillance of issuer hedge transactions, early exercise notification and reporting requirements for index warrants.[7] Amendment No. 4 (''Amendment No. 4'') addresses surveillance issues related to the trading of index warrants.[8] Amendment No. 5 clarifies the settlement procedures for index warrant which are exercised at or prior to expiration.[9] This order approves the proposal, as amended.

II. Description of the Proposal

The CBOE proposes to establish uniform rules for the listing and trading of stock index, currency and currency index warrants.[10] This filing incorporates the results of numerous communications with the Commission staff and other exchanges, including comments contained in a letter from Sharon Lawson to Joanne Moffic-Silver dated January 28, 1993 (''Lawson letter''). This filing also makes certain changes in the listing criteria for stock index and currency warrants and makes clear that certain rules applicable to currency warrants would apply equally to currency index warrants.

Exercise and Position Limits

The Exchange is proposing position limits for stock index warrants that, in general, are approximately 75%, in terms of underlying dollar value, of the current position limits for index options. Accordingly, proposed Rule 30.35(a) provides that position limits for stock index warrants on the same index with original issue prices of ten dollars or less will be fifteen million warrants covering all such issues.[11] In addition, with respect to warrants on the Russell 2000 Index, the position limit will be twelve and one half million warrants covering all such issues, provided the original issue prices of the warrants are not greater than ten dollars. The rule provides that warrants with an original issue price of greater than ten dollars will be weighted more heavily than warrants with an original issue price of ten dollars or less in calculating position limits.[12]

Proposed Rule 30.35(d) also gives the Exchange the authority to require the liquidation of a position in stock index warrants that is in excess of the position limits set forth in the rule.[13]

Proposed Rule 30.35(b) also establishes exercise limits on stock index warrants which are analogous to those found in stock index options. The rule prohibits holders from exercising, within any five consecutive business days, long positions in warrants in excess of the base position limit established in Rule 30.35(a).

In order to facilitate its review of compliance with position and exercise limits, proposed rule 30.35(d) establishes reporting requirements for large warrant positions. Under the terms of the Rule, members will be required to file a report with the Exchange whenever any account in which the member has an interest has established an aggregate position of 100,000 warrants overlying the same index, currency or currency index.[14] For

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[45] 15 U.S.C. § 78s(b)(2) (1988).

[46] 17 CFR 200.30–3(a)(12) (1994).

[1] 15 U.S.C. 78s(b)(1) (1988 & Supp. V 1993).

[2] 17 CFR 240.19b-4 (1994).

[3] Securities Exchange Act Release No. 35178 (Dec. 29, 1994), 60 FR 2409.

[4] *See* Letter from Paul M. Gottlieb, Seward & Kissel, to Jonathan G. Katz, Secretary, Commission, dated January 10, 1995 (''Comment Letter'' or ''Seward & Kissel Letter'').

[5] Letter from Janet Angstadt, Schiff Hardin & Waite, to Michael Walinskas, SEC, dated March 2, 1995.

[6] Letter from Timothy Thompson, CBOE, to Michael Walinskas, SEC, dated May 8, 1995.

[7] Letter from James R. McDaniel, Schiff Hardin & Waite, to Michael Walinskas, SEC, dated June 23, 1995.

[8] Letter from Janet Angstadt, Schiff Hardin & Waite, to Michael Walinskas, SEC, dated August 4, 1995.

[9] Letter from Janet Angstadt, Schiff Hardin & Waite, to Michael Walinskas, SEC, dated August 18, 1995.

[10] The proposed rules would apply to both American-style warrants (which may be exercised at any time prior to expiration) and European-style warrants (which may be exercised only during a specified period before expiration).

[11] *See infra* note 47.

[12] For example, if an investor held 100,000 warrants based upon the Standard & Poor's 500 Index offered originally at $20 per warrant, the size of this position for the purpose of calculating position limits would be 200,000.

[13] Proposed Rule 30.35(d) makes Rule 4.14 (Liquidation of Positions) applicable to index warrants.

[14] *See* Amendment No. 2. In the original filing, the CBOE proposed establishing a reportable limit for stock index warrants at 20,000 warrants. Amendment No. 2 extended the reporting

purposes of this rule, the Exchange proposes that positions on the same side of the market be aggregated together (*e.g.*, long positions in puts be combined with short positions in call warrants, and short positions in puts be combined with long positions in call warrants).[15]

Margin

The Exchange's proposed margin requirements for customers having positions in index warrants, currency index warrants and currency warrants are included in proposed new Rule 30.52. In general, the proposed margin requirements for long and short positions in stock index warrants are the same as margin requirements for positions in stock index options and the margin requirements for long and short positions in currency warrants are the same as those for corresponding currency options. Thus, all purchases of warrants will require payment in full, and short sales of stock index warrants will require initial margin of: (i) 100 percent of the current value of the warrant plus (ii) 15 percent of the current value of the underlying broad stock index less the amount by which the warrant is out of the money, but with a minimum of ten percent of the index value. Short sales of currency warrants will follow the margin requirements currently applicable to listed currency options. Specifically, the Exchange proposes that short sales of warrants on the German Mark, French Franc, Swiss Franc, Japanese Yen, British Pound, Australian Dollar and European Currency Unit shall each be subject to margin level of 100% of the current market value of each such warrant plus a four percent ''add-on.''[16] The margin required on currency index warrants would be an amount as determined by the Exchange and approved by the Commission.[17] The Exchange also proposes that its stock index, currency and currency index warrant margin requirements be permitted offset treatment for spread and straddle positions. In this regard, the Exchange proposes that index, currency and currency index warrants may be offset with either warrants or Options Clearing Corporation (''OCC'') issued options on the same index, currency or currency index, respectively. Furthermore, the Exchange has proposed that Rules 30.35(d)(i), (ii) and (iii), to the extent that such rules concern spread and straddle positions in warrants, be subject to a one year pilot basis.[18] Finally, proposed Rule 30.53(d)(iv) will permit the use of escrow receipts to cover a short position in a broad-based stock index warrant.[19]

CBOE believes that a broker-dealer carrying positions in warrants must bear in mind that special characteristics of warrants—such as pricing differences, the necessity of borrowing to make delivery on short sales, and the issuer credit risk associated with long warrants—may cause these margin requirements to be insufficient to fully cover the risk of such positions in certain circumstances, and broker-dealers must therefore be prepared to call for additional margin when appropriate. CBOE further believes that each exchange listing stock index, currency index or currency warrants should draw the attention of its member firms to this issue in connection with the adoption of these margin rules.

In accordance with the Lawson letter, the proposed rules would be applicable only to warrants issued after the effective date of this filing. Warrants issued prior to that date would remain subject to the rules in effect at the time of their listing.

Customer Protection

Modifications are proposed to Exchange Rule 30.50, Doing Business With the Public, to incorporate references to proposed new Rule 30.52. Proposed Rule 30.52(c) states that no member or member organization shall accept an order from a customer for the purchase or sale of warrants unless the customer's account has been approved for options trading pursuant to Exchange Rule 9.7. Accordingly, the Exchange will rescind Interpretation .02 to Rule 30.52, its current suitability standard applicable to warrants, which currently provides that the Exchange ''recommends'' that index and currency warrants only be sold to investors whose accounts have been approved for options trading. Appendix A to Chapter XXX, which is a cross-reference table to other rules of the Exchange that are applicable to securities otherwise covered in Chapter XXX, is being updated to reflect the applicability of certain options rules (*i.e.*, customer protection rules including, but not limited to, account supervision, suitability, etc.) to warrants:

Rule 4.13 Reports Related to Position Limits
Rule 4.14 Liquidation of Positions
Rule 9.2 Registration of Options Principals
Rule 9.6 Registration of Branch Offices
Rule 9.7 Account Approval Requirements
Rule 9.8 Supervision Requirements
Rule 9.9 Suitability Requirements
Rule 9.10 Discretionary Account Requirements
Rule 9.21 Requirements for Customer Communications
Rule 9.23 Record-keeping Requirements for Customer Complaints

Listing Criteria

The listing criteria for stock index warrants and currency warrants are being amended to reflect the comments contained in the Lawson letter and to make clear that they apply to currency index warrants. In particular, proposed Rule 31.5(E) (1) and (4) provide that issuers are required to have a minimum tangible net worth in excess of $250 million or, in the alternative, have a minimum tangible net worth in excess of $150 million, provided that the issuer does not have (including as a result of the proposed issuance) issued outstanding warrants where the aggregate original issue price of all such warrant offerings (combined with offerings by its affiliates) listed on a national securities exchange or that are National Market securities traded through NASDAQ exceeds 25% of the issuer's net worth.[20]

Second, proposed Rule 31.5(E)(6) requires that unexercised in-the-money warrants be automatically exercised on either the delisting date (if the issue is not listed upon another organized securities market) or upon expiration. Third, proposed Rule 31.5(E)(5) provides that for warrant offerings where U.S. stocks constitute 25% or more of the index value (''domestic index''), issuers shall use opening prices (''a.m. settlement'') for U.S. stocks to determine index warrant settlement values on the final determination of settlement value date (''valuation date'') as well as during the two business days

requirement to currency and currency index warrants at a level of 100,000 warrants (on the same side of the market). Finally, Amendment No. 3 proposed raising the reporting requirement for stock index warrants from 20,000 to 100,000 warrants (on the same side of the market).

[15] *See* Amendment Nos. 2 and 3.

[16] *See* Amendment No. 3. Consistent with the treatment of options on foreign currencies, warrants on the Canadian Dollar will be subject to a one percent ''add-on.'' The margin required on any other foreign currency would be subject to approval by the Commission. *See infra* note 34.

[17] *See infra* note 17.

[18] Three months prior to the expiration of the pilot program, the Exchange will submit a report to SEC staff analyzing the price relationship between listed warrants and options on similar stock indexes. *See* Amendment No. 1. The Exchange has also requested no-action relief from the Commission in order to permit certain short positions in stock index call and put warrants to be treated as covered for margin purposes.

[19] *See* Amendment No. 1. The Exchange notes that this treatment is consistent with the rules that allow for the use of escrow receipts to cover a short call position in broad-based stock index options.

[20] *See* Amendments No. 1 and 3. The Exchange amended this provision in response to the Seward & Kissell Letter.

prior to valuation date.[21] Fourth, Rule 31.5(E)(7) has been amended to provide that foreign country securities or American Depositary Receipts (''ADRs'') thereon that are not subject to a comprehensive surveillance sharing agreement with the Exchange and that have less than 50% of their global trading volume (in dollar value) within the U.S., shall not represent more than 20% of the weight of the index.[22] Finally, the Exchange proposes to add Rule 31.5(E)(8) in order to assist in the surveillance of index warrant trading. Specifically, the Exchange will require issuers of stock index warrants to notify the Exchange of any early exercises by no later than 3:30 p.m. (Chicago time) on the day that the settlement value for the warrants is determined.[23]

Trading Halts or Suspensions

Proposed new Rule 30.36 makes the provisions in Rule 24.7 concerning trading halts or suspensions in stock index options applicable to stock index warrants.

Specific Warrant Issues

Upon Commission approval of the foregoing rule amendments, the Exchange proposes that it will only file rule changes for specific stock index warrant issuances where there is no corresponding option or warrant on the same underlying stock index already listed on a national securities exchange or included for quotation on NASDAQ. Accordingly, when a listed option overlies a particular broad based index, the Exchange proposes it be allowed to list warrants on that index without further Commission review and approval pursuant to Section 19(b) of the Act as long as the listing complies with the warrant listing standards as approved in this Order.[24] Finally, prior to trading stock index or currency warrants, the Exchange will distribute circulars to its membership providing guidance regarding member firm compliance responsibilities (including suitability recommendations) when handling transactions in warrants.

III. Comments Received

The Commission received one letter in response to its request for comments on the CBOE proposal.[25] The Comment Letter was generally supportive of the CBOE's proposal, however, it recommended several changes in the proposed regulatory structure applicable to stock index, currency and currency index warrants. The Comment Letter was submitted on behalf of the Firms, all of whom are represented to be major participants in the issuance, underwriting and trading of warrants. Because the proposed regulatory regime applicable to warrants will, to some extent, be based upon the rules governing standardized options, the Comment Letter states that the Firms' comments are driven, in part, by the fact that fundamental differences exist between warrants and standardized options which necessitate disparate regulatory treatment in certain situations.[26]

First, the Comment Letter suggested amending the issuer Listing Standards to eliminate the 25% test or, in the alternative, to adopt hedging and/or netting standards designed to more accurately reflect issuer-specific risk.[27] Because warrants are sold by means of a registration statement, the Firms believe that adequate disclosure of the amount of an issuer's outstanding securities could be included in the prospectus. Furthermore, the Comment Letter points out that issuers of warrants are traditionally subject to outside evaluation by certain credit rating agencies, which should assist investors in determining undue issuer credit risk. Finally, the Firms do not believe the 25% test bears any resemblance to an issuer's risk exposure since exposure fluctuates with market changes at any given time and also because the proposal provides no recognition for offsetting hedges or for warrants subject to netting.

In response to the Seward & Kissel Letters's comments respecting issuer listings standards, the CBOE amended the filing to add an alternative issuer qualification criteria.[28] Under the new criteria, an issuer will be required to either: (a) have a minimum tangible net worth of $250 million; or (b) meet the existing criteria (*i.e.*, tangible net worth of $150 million and meet the 25% test).

The Comment Letter also recommended allowing the use of p.m. settlement for all American-style warrants exercised anytime except 48 hours prior to expiration, at which time a.m. settlement would be required. According to the Comment Letter, unlike with listed options (where OCC is the issuer and runs a balanced book), a warrant issuer must hedge its exposure to maintain offsetting positions. Upon early exercise of the warrants, the issuer that has hedged its exposure will have to take action to ''unwind'' the portion of its hedge relating to the exercised warrants. The Firms believe that requiring a.m. settlement on the first day after an investor exercises the warrant will place additional market risk upon them due to the difficulty in managing the hedge. This increased hedging cost, the Firm's argue, could result in a higher issuance price for the warrant or could require that the warrant settlement value date be postponed an additional day, with warrant holders bearing additional market risk during this period.

In response to the Comment Letter, the CBOE amended its filing to include a provision permitting p.m. settlement for stock index warrants except for a short period before expiration.[29] Under the terms of the amendment, stock index warrants for which 25% or more of the value of the underlying index is represented by securities that are traded primarily in the U.S. shall, by their terms, provide that, on valuation date, as well as for the two business days prior to valuation date, the value of the stocks traded primarily in the U.S. which underlie such warrants shall be determined by reference to the opening prices of such underlying U.S. securities. For example, if the valuation date for an issuance of index warrants occurs on a Friday, a.m. settlement must be utilized for warrants that are valued on the preceding Wednesday or

[21] *See* Amendment No. 5. The Exchange amended its proposal in response to the Seward & Kissell Letter and notes that a warrant based upon a domestic U.S. stock index may be settled using closing prices (''p.m. settlement'') for the underlying stocks at all times except for the warrants valuation day and the two business days immediately preceding valuation date.

[22] *See* Amendment No. 1.

[23] *See* Amendment No. 3.

[24] *See infra* note 34.

[25] *See supra* note 4. The Seward & Kissel Letter was submitted on behalf of PainWebber Inc., Bear, Stearns & Co. Inc., Lehman Brothers Inc., Smith Barney Inc., Salomon Brothers Inc., Morgan Stanley & Co. Inc., and Hambrecht & Quist Inc. (collectively the ''Firms'').

[26] The Comment Letter lists several differences which it perceives exist between warrants and standardized options. Chief among these are: (1) warrants are separately registered, unsecured obligations of their issuer while options are issued and guaranteed by the Options Clearing Corp. (''OCC''); (2) during the prospectus delivery period, warrant purchasers receive a product-specific prospectus while options customers receive an options disclosure document (''ODD'') at the time the account is opened; (3) each warrant creates a fixed number of outstanding warrants while there is theoretically no limit to the number of options that may be issued by OCC; and (4) warrants are traded on an exchange in a manner similar to stocks which, therefore, translates into superior price transparency than for listed options.

[27] As originally proposed, an issuer would have been required to have a tangible net worth of at least $150 million and the aggregate original issue price of all of a particular issuer's warrant offerings (combined with such offerings by its affiliates) that are listed on a national securities exchange or that are national market securities traded through NASDAQ was not to exceed 25% of the issuer's net worth (''25% test).

[28] *See* Amendment No. 1.

[29] *See* Amendments No. 3 and 5.

Thursday, as well as on the valuation date.

Third, the Comment Letter recommended creating a special category of ''warrant eligible'' customers (separate and distinct from options eligibility criteria), who are authorized to trade warrants even if not approved to trade options. The Firms believe it is inappropriate to apply an options regulatory regime to warrants and that doing so may prevent institutional customers who are not permitted to purchase options products, yet who nevertheless meet all of the options eligibility criteria, from purchasing warrants. In this regard, the Firms propose to create a ''warrant eligible'' category with standards mimicking those currently required for options approved accounts. As such, ''warrant-approved'' accounts could purchase warrants, however, they could not purchase options or other products requiring options account approval. The CBOE did not amend its filing in response to this comment.

Fourth, the Comment Letter urges the adoption of a rule permitting firms to approve for warrant trading those accounts managed by an investment adviser (''IA'') based upon the IA's representation concerning the eligibility status of its customers to engage in warrant trading, even if the underlying documentation relating to the managed accounts is not provided to the brokerage firms. The CBOE has amended its proposal to allow member firms to accept the representation of an investment adviser registered under the Investment Advisers Act of 1940 concerning the eligibility status of its customers to engage in warrant trading, even if the underlying documentation relating to the managed account is not provided to the member firm, where the managed account is for an institutional customer or the investment advisor account represents the collective investment of a number of persons. The CBOE states that this will conform the handling of warrant accounts to the current practice with respect to listed options accounts.[30]

Finally, the Comment Letter addressed the proposed position limits applicable to warrants. Specifically, the Comment Letter noted that position limits for warrants would be set at levels that are approximately 75% of that allowed for similar broad-based indexes. The Comment Letter recommended establishing position limits for warrants that were equivalent to those established for listed options, allowing a hedge exemption similar to listed option procedures and providing a mechanism for specific waivers or exemptions of warrant position limits for hedgers, market-makers and broker-dealers comparable to the procedures in place for listed options. The CBOE did not amend its filing in response to this comment.

IV. Discussion

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).[31] Specifically, the Commission finds that the Exchange's proposal to establish uniform listing standards for broad-based stock index, currency and currency index warrants strikes a reasonable balance between the Commission's mandates under Section 6(b)(5) to remove impediments to and perfect the mechanism of a free and open market and a national market system, while protecting investors and the public interest. In addition, the CBOE's proposed listing standards for warrants are consistent with the Section 6(b)(5) requirements that rules of an exchange be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, and are not designed to permit unfair discrimination among issuers.

The CBOE's proposed generic listing standards for broad-based stock index warrants, currency and currency indexes set forth a regulatory framework for the listing of such products.[32] Generally, listing standards serve as a means for an exchange to screen issuers and to provide listed status only to *bona fide* issuances that will have sufficient public float, investor base, and trading interest to ensure that the market has the depth and liquidity necessary to maintain fair and orderly markets. Adequate standards are especially important for warrant issuances given the leverage and contingent liability they represent. Once a security has been approved for initial listing, maintenance criteria allow an exchange to monitor the status and trading characteristics of that issue to ensure that it continues to meet the exchange's standards for market depth and liquidity so that fair and orderly markets can be maintained.

In reviewing listing standards for derivative-based products, the Commission also must ensure that the regulatory requirements provide for adequate trading rules, sales practice requirements, margin requirements, position and exercise limits and surveillance procedures. These rules minimize the potential for manipulation and help to ensure that derivatively-priced products will not have a negative market impact. In addition, these standards should address the special risks to consumers arising from the derivative products.[33] For the reasons discussed below, the Commission believes the CBOE's proposal will provide it with significant flexibility to list index, currency and currency index warrants, without compromising the effectiveness of the Exchange's listing standards or regulatory program for such products.[34]

A. Issuer Listing Standards and Product Design

As a general matter, the Commission believes that the trading of warrants on a stock index, currency or currency index permits investors to participate in the price movements of the underlying assets, and allows investors holding positions in some or all of such assets

[30] *See* Amendment No. 1.

[31] 15 U.S.C. 78f(b)(5) (1982).

[32] The Commission notes that warrants issued prior to this approval order will continue to be governed by the rules applicable to them at the time of their listing.

[33] Pursuant to Section 6(b)(5) of the Act, the Commission is required to find, among other things, that trading in warrants will serve to protect investors and contribute to the maintenance of fair and orderly markets. In this regard, the Commission must predicate approval of any new derivative product upon a finding that the introduction of such derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument that served no hedging or other economic function, because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. As discussed below, the Commission believes warrants will serve an economic purpose by providing an alternative product that will allow investors to participate in the price movements of the underlying securities in addition to allowing investors holding positions in some or all of such securities to hedge the risk associated with their portfolios.

[34] Issuances of warrants overlying a single currency may currently be listed for trading without a rule filing provided that the underlying currency is one of the original seven foreign currencies approved for options trading: the Australian Dollar, British Pound, Canadian Dollar, French Franc, German Mark, Japanese Yen, Swiss Franc and the European Currency Unit. Issuances of currency warrants overlying any other foreign currency would require a rule filing pursuant to Section 19(b) of the Act. The Commission notes that currency index warrants may only be established without a further rule filing upon an index that has been previously approved by the Commission pursuant to a Section 19(b) filing. To date, the only currency index approved pursuant to Section 19(b) is an equal-weighted index comprised of the British Pound, Japanese Yen and German Deutsche Mark. *See* Securities Exchange Act Release No. 31627 (Dec. 21, 1992), 57 FR 62399 (Dec. 30, 1992). Accordingly, any other currency index (as well as a broad-based stock index) not previously approved by the Commission would require approval pursuant to Section 19(b).

to hedge the risks associated with their portfolios. The commission further believes that trading warrants on a stock index, currency or currency index provides investors with an important trading and hedging mechanism that is designed to reflect accurately the overall movement of the component securities.

Warrants, unlike standardized options, however, do not have a clearinghouse guarantee but are instead dependent upon the individual credit of the issuer. This heightens the possibility that an exerciser of warrants may not be able to receive full cash settlement upon exercise. This additional credit risk, to some extent, is reduced by the Exchange's issuer listing standards that require an issuer to have either; (a) a minimum tangible net worth of $250 million; or (b) a minimum tangible net worth of $150 million, provided that the issuer does not have (including as a result of the proposed issuance) issued outstanding warrants where the aggregate original issue price of all such stock index, currency or currency index warrant offerings (or affiliates) that are listed on a national securities exchange or traded through the facilities of NASDAQ is in excess of 25% of the warrant issuer's net worth. Furthermore, financial information regarding the issuers of warrants will be disclosed or incorporated in the prospectus accompanying the offering of the warrants. Moreover, the alternative test addresses the Comment Letter's concerns on the 25% standard.

The CBOE's proposal will provide issuers flexibility by allowing them to utilize either a.m. or p.m. settlement, provided, however, domestic index warrants (*i.e.*, warrants based on indexes for which 25% or more of the index value is represented by securities traded primarily in the U.S.) (''domestic index warrants'') are required to utilize a.m. settlement for warrants on valuation date as well as during the last two business days prior to valuation date.[35] The Commission continues to believe that a.m. settlement significantly improves the ability of the market to alleviate and accommodate large and potentially destabilizing order imbalances associated with the unwinding of index-related positions. Nevertheless, in accordance with the Comment Letter's suggestions, the use of p.m. settlement except during the last two business days prior to a domestic index warrant's valuation date, as well as the valuation date, strikes a reasonable balance between ameliorating the price effects associated with expirations of derivative index products and providing issuers with flexibility in designing their products.[36] In this context, the Commission notes that unlike standardized index options whose settlement times are relatively uniform, index warrants are issuer-based products, whose terms are individually set by the issuer. In addition, while options may have unlimited open interest, the number of warrants on a given index is fixed at the time of issuance. Accordingly, it is not certain that there will be a significant number of warrants in indexes with similar components expiring on the same day. This may reduce the pressure from liquidation of warrant hedges at settlement. Nevertheless, the Commission expects the Exchange to monitor this issue and, should significant market effects occur as a result of early exercises from p.m. settled index warrants, would expect it to make appropriate changes including potentially limiting the number of index warrants with p.m. settlement.

B. Customer Protection

Due to their derivative and leveraged nature, and the fact that they are a wasting asset, many of the risks of trading in warrants are similar to the risks of trading standardized options. Accordingly, the CBOE has proposed to apply its options customer protection rules to warrants. In particular, the Commission notes that warrants may only be sold to options approved accounts capable of evaluating and bearing the risks associated with trading in these instruments, in accordance with CBOE Rule 9.7, and that adequate disclosure of the risks of these products must be made to investors.[37] In addition, the CBOE will apply the options rules for suitability, discretionary accounts, supervision of accounts and customer complaints to transactions in warrants. By imposing the special suitability and disclosure requirements noted above, the Commission believes the CBOE has addressed adequately several of the potential customer protection concerns that could arise from the options-like nature of warrants.

The ODD, which all options approved accounts must receive, generally explains the characteristics and risks of standardized options products. Although many of the risks to the holder of an index warrant and option are substantially similar, however, because warrants are issuer-based products, some of the risks, such as the lack of a clearinghouse guarantee and certain terms for index warrants, are different. The CBOE has adequately addressed this issue by proposing to distribute a circular to its members that will call attention to the specific risks associated with stock index, currency and currency index warrants that should be highlighted to potential investors. In addition, the issuer listing guidelines described above will ensure that only substantial companies capable of meeting their warrant obligations will be eligible to issue warrants. These requirements will help to address, to a certain extent, the lack of a clearinghouse guarantee for index warrants. Finally, warrant purchasers will receive a prospectus during the prospectus delivery period. The Commission believes that this will ensure that certain information about the particular issuance and issuer is publicly available.

As noted above, the Comment Letter indicates that applying the options disclosure framework to warrants is inappropriate. However, the Commission believes that the combined approach of making available general derivative product information (the ODD), product specific information (the Exchange circular), and issuer specific information (the prospectus) should provide an effective disclosure mechanism for these products.

At this time, the Commission does not agree with the proposal contained in the Comment Letter to create a special ''warrant eligible'' classification of purchasers. As noted above, index, currency and currency index warrants are very similar to standardized options. They are so similar that a customer precluded from trading options should not avoid the restriction indirectly by being designated by Exchange rules as eligible for stock index, currency or currency index warrants. Nevertheless, as the range of exchange-traded derivative products increases, the SROs might consider in the future as to whether a new derivatives eligibility classification is appropriate.

C. Surveillance

In evaluating proposed rule changes to list derivative instruments, the Commission considers the degree to which the market listing the derivative product has the ability to conduct adequate surveillance. In this regard the Commission notes that the Exchange has developed adequate surveillance procedures for the trading of index and currency warrants. First, new issues of

[35] Currency and currency index warrants are not limited to a.m. or p.m. settlement.

[36] Foreign stock market based index warrants may utilize p.m. settlement throughout their duration.

[37] Pursuant to CBOE Rule 9.7, all options approved accounts must receive an ODD, which discusses the characteristic and risks of standardized options.

currency warrants will be subject to the CBOE's existing surveillance procedures applicable to foreign currency warrants, which the Commission previously has found to be adequate to surveil for manipulation and other abuses involving the warrant market and the underlying foreign currencies.[38]

Second, the Exchange has developed enhanced surveillance procedures to apply to domestic stock index warrants which the Commission believes are adequate to surveil for manipulation and other abuses involving the warrant market and component securities.[39] Among these enhanced surveillance procedures, the Commission notes that issuers will be required to report to the Exchange on settlement date the number and value of domestic index warrants subject to early exercise the previous day. The Commission believes that this information will aid the CBOE in its surveillance capacity and help it to detect and deter market manipulation and other trading abuses.

Third, the Exchange had developed adequate surveillance procedures to apply to foreign stock index warrants (*i.e.*, less than 25% of the index value is derived from stocks traded primarily in the U.S.).[40] The Commission believes that the ability to obtain information regarding trading in the stocks underlying an index warrant is important to detect and deter market manipulation and other trading abuses. Accordingly, the Commission generally requires that there be a surveillance sharing agreement[41] in place between an exchange listing or trading a derivative product and the exchange(s) trading the stocks underlying the derivative contract that specifically enables the relevant markets to surveil trading in the derivative product and its underlying stocks.[42] Such agreements provide a necessary deterrent to manipulation because they facilitate the availability of information needed to fully investigate a potential manipulation if it were to occur.[43] In this regard, the CBOE will require that no more than 20% of an Index's weight may be comprised (upon issuance and thereafter) of foreign securities (or ADRs thereon) that do not satisfy one of the following tests: (1) The Exchange has in place an effective surveillance agreement[44] with the primary exchange in the home country in which the security underlying the ADR is traded; or (2) meets an existing alternative standard available for standardized options trading (*e.g.*, satisfy the 50% U.S. trading volume test).[45] The Commission believes that this standard will ensure that index warrants are not listed upon foreign indexes whose underlying securities trade on exchanges with whom the CBOE has no surveillance sharing agreement.

D. Market Impact

The Commission believes that the listing and trading of index warrants, currency warrants and currency index warrants will not adversely affect the U.S. securities markets or foreign currency markets. First, with respect to currency and currency index warrants, the Commission notes that the interbank foreign currency spot market is an extremely large, diverse market comprised of banks and other financial institutions worldwide. That market is supplemented by equally deep and liquid markets for standardized options and futures on foreign currencies and options on those futures. An active over-the-counter market also exists in options, forwards and swaps for foreign currencies. This minimizes the possibility that Exchange listed warrants would be used to manipulate the spot currency markets. In addition, the surveillance procedures for these products should allow the Exchange to detect and deter potential manipulation involving currency warrants and currency index warrants.

Second, with respect to index warrants, the Commission notes that warrants may only be established upon indexes the Commission has previously determined to be broad-based in the context of index options or warrant trading. As part of its review of a proposal to list an index derivative product, the Commission must find that the trading of index options or warrants will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets. Accordingly, the Commission does not believe that the issuance of index warrants upon previously approved broad based stock index options or warrants will adversely impact the underlying component securities. In addition, because index warrants are issued by various individual issuers who set their own terms, it is likely that expirations among similar index products will be varied, thereby reducing the likelihood that unwinding hedge activities would adversely affect the underlying cash market. Finally, as discussed above, the Commission believes the CBOE's enhanced surveillance procedures applicable to stock index warrants are adequate to surveil for manipulation and other abuses involving the warrant market, component securities and issuer hedge unwinding transactions.

Third, the Exchange has proposed margin levels for stock index and currency warrants equivalent to those in place for stock index and currency options. The Commission believes these requirements will provide adequate customer margin levels sufficient to account for the potential volatility of these products. In addition, options margin treatment is appropriate given the options-like market risk posed by warrants. The Commission notes that the customer spread margin treatment applicable to warrants is subject to a one year pilot program. This will allow the Exchange to analyze the pricing relationships between listed options and warrants on the same index in order to determine whether to revise or approve

[38] *See* Securities Exchange Act Release No. 24555 (June 5, 1987), 52 FR 22570 (June 12, 1987), and Securities Exchange Act Release No. 26152 (Oct. 3, 1988), 53 FR 39832 (Oct. 12, 1988). The Commission notes that these surveillance procedures only apply to the issuance of warrants overlying one of the approved foreign currencies. *See supra* note 34. The issuance of warrants upon any other foreign currency would necessitate a Section 19(b) rule filing which, among other things, details applicable surveillance procedures.

[39] In addition, the Commission notes that issuers will be required to report to the Exchange all trades to unwind a warrant hedge that are effected as a result of the early exercise of domestic index warrants. This will enable the Exchange to monitor the unwinding activity to determine if it was effected in a manner that violates Exchange or Commission rules.

[40] Each prior issuance of a foreign stock market-based index warrant is subject to specific surveillance procedures. These procedures are generally tailored to the individual warrant issuance and are based upon several factors involving the primary foreign market, including the existence of surveillance or information sharing agreements.

[41] The Commission believes that a surveillance sharing agreement should provide the parties with the ability to obtain information necessary to detect and deter market manipulation and other trading abuses. Consequently, the Commission generally requires that a surveillance sharing agreement require that the parties to the agreement provide each other, upon request, information about market trading activity, clearing activity, and the identity of the ultimate purchasers for securities. *See e.g.*, Securities Exchange Act Release No. 31529 (Nov. 27, 1992).

[42] The ability to obtain relevant surveillance information, including, among other things, the identity of the ultimate purchasers and sellers of securities, is an essential and necessary component of a comprehensive surveillance sharing agreement.

[43] In the context of domestic index warrants, the Commission notes that the U.S. exchanges are members of the Intermarket Surveillance Group (''ISG''), which was formed to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. *See* Intermarket Surveillance Group Agreement, July 14, 1983. The most recent amendment to the ISG Agreement, which incorporates the original agreement and all the amendments made thereafter, was signed by ISG members on January 29, 1990. *See* Second Amendment to the ISG Agreement.

[44] *See supra* note 41.

[45] *See* Securities Exchange Act Release Nos. 31529, 57 FR 57248 (Dec. 3, 1992) and 33555, 59 FR 5619 (Feb. 7, 1994).

on a permanent basis the proposed spread margin rules.[46]

Fourth, the CBOE has established reasonable position and exercise limits for stock index warrants, which will serve to minimize potential manipulation and other market impact concerns.[47] Contrary to the views expressed in the Comment Letter, the Commission believes that in the absence of trading experience with domestic index warrants, it would be imprudent to establish position limits for positions greater than those currently applicable to domestic stock index options on the same index.[48]

V. Conclusion

The Commission believes that the adoption of these uniform listing and trading standards covering index, currency and currency index warrants will provide an appropriate regulatory framework for these products. These standards will also benefit the Exchange by providing them with greater flexibility in structuring warrant issuances and a more expedient process for listing warrants without further Commission review pursuant to Section 19(b) of the Act. As noted above, additional Commission review of specific warrant issuances will generally only be required for warrants overlying any non-approved broad-based index or a non-approved currency or currency index. If Commission review of a particular warrant issuance is required, the Commission expects that, to the extent that the warrant issuance complies with the uniform criteria adopted herein, its review should generally be limited to issues concerning the newly proposed index. This should help ensure that such additional Commission review could be completed in a prompt manner without causing any unnecessary delay in listing new warrant products.

The Commission finds good cause for approving Amendments No. 1, 2, 3, 4 and 5 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register** for the following reasons. As discussed below, the changes are either (1) minor and technical in nature; (2) responsive to the Comment Letter; (3) designed to conform to warrant proposals from other markets; or (4) modifications to Exchange surveillance procedures. Accordingly, the amendments do not raise new significant regulatory issues or are responsive to prior comments. In order to enable the Exchange to list new index, currency or currency index warrants as soon as possible, the Commission believes it is necessary and appropriate to approve the amendments on an accelerated basis.

Amendment No. 1 makes several changes to the filing which are designed to bring it into conformity with the other options exchanges. First, it revises Rule 31.5(E) in several respects to provide uniform issuer listing standards. The first two changes provide an alternative issuer listing qualification criteria (as discussed above under *Issuer Listing Standards and Product Design*) and limit the number of foreign securities that may comprise an underlying stock index. The Commission notes that the first change was made in response to comments received from the Seward & Kissell Letter and further believes it will provide added flexibility to issuers without compromising investor protection concerns. The Commission believes the second change strengthens the issuer listing standards to the benefit of warrant investors.

Amendment No. 1 also revises Rule 462 to provide that the proposed spread and straddle margin treatment for stock index warrants will be effected as part of a one year pilot program, and to provide that escrow receipts will be accepted to cover short positions in stock index warrants. The Commission notes that these changes conform the margin treatment afforded options and warrants and provide a basis for evaluating pricing correlations between warrants and options overlying the same index, currency or currency index.

Finally, Amendment No. 1 provides that the Exchange will permit member firms to accept an IA's representation concerning the options eligibility status of its customers, as described above. The Commission notes this practice is consistent with the treatment of options and, therefore, raises no new or unique regulatory issues. Accordingly, for the reasons discussed above relating to each proposed revision of the Amendment, the Commission believes it is appropriate to approve Amendment No. 1, to the Exchange's proposal on an accelerated basis.

Amendment No. 2 establishes that currency and currency index warrants will be subject to reporting levels in the same manner as stock index warrants. The Commission notes that this revision helps to provide uniformity in the regulatory treatment of warrants. Furthermore, because currency and currency index warrants are not subject to position and exercise limits, the Commission believes that requiring investors to report to the Exchange when their holdings exceed specified levels should aid the Exchange in its monitoring for potential trading abuses involving currency and currency index warrants.[49] Accordingly, the Commission believes it is appropriate to approve Amendment No. 2 on an accelerated basis.

Amendment No. 3 to the proposal clarifies several issues relating to a.m. settlement, position reporting for index warrants, and other surveillance related matters. In particular, it provides that issuers must report all hedge unwinding transactions related to the early exercise of domestic index warrants to the listing exchange by the business day following trade date (''T+1'').[50] Also, the Amendment requires issuers to notify the listing exchange of any early exercises of index warrants by 3:30 p.m. (Chicago time) on settlement date for the warrants. The Commission believes these changes to the CBOE's surveillance procedures strengthen the Exchange's monitoring of index warrants. Also, the Amendment clarifies that a.m. settlement will be used during the 48 hour period prior to expiration of index warrants. The Commission notes that this change simply codifies a provision the CBOE previously agreed to in Amendment No. 2.[51] Finally, the Amendment raises the reporting level requirement for index warrants from 20,000 warrants to 100,000 warrants on the same side of the market. The Commission notes that this change

[46] The Commission notes that the margin levels for currency index warrants will be set at a level determined by the Exchange and approved by the SEC. *See* Amendment No. 4. Issuances of warrants listed prior to the approval of this order will continue to apply the margin level applicable to them at the time of their listing.

[47] The Commission notes that there are no position or exercise limits applicable to currency or currency index warrants, although reporting requirements do apply. Nevertheless, the Commission may review the need to establish foreign currency position limits if the size of the currency or currency index warrant market increases significantly.

[48] With respect to the Comment Letter's suggestion that a hedge exemption rule be established in order to allow participants to readily acquire exemptions from the Exchange as needed, the Commission does not believe that such an approach is appropriate at this time. The hedge exemption for index options was adopted after several years experience with index options trading. Until the SROs gain some experience with domestic index warrant trading, it is difficult to determine the need for a hedge exemption (*i.e.*, that speculative limits are insufficient to meet hedging needs).

[49] Amendment No. 3 proposes to raise the reporting requirement for stock index warrants from 20,000 to 100,000 warrants.

[50] The Commission notes that Amendment No. 4 removes this transaction reporting requirement which will be incorporated into the Exchange's surveillance procedures.

[51] Amendment No. 5 subsequently changes the language of this provision to require a.m. settlement be used during the two business days prior to valuation date.

provides uniform treatment to index, currency and currency index warrants and should aid the Exchange's surveillance procedures. Accordingly, the Commission believes it is appropriate to approve Amendment No. 3 on an accelerated basis.

Amendment No. 4 deletes a transaction reporting requirement which will be revised and incorporated into the Exchange's surveillance procedures and also makes other minor changes. As such, the Commission does not believe the Amendment raises any new or unique regulatory issues. Second, the Amendment clarifies that the applicable margin level for currency index warrants will be a percentage as specified by the exchange and approved by the Commission. The Commission notes that this revision is consistent with the treatment afforded currency index options, where margin levels are established on a case by case basis. Accordingly, the Commission believes it is appropriate to approve Amendment No. 4 on an accelerated basis.

Amendment No. 5 clarifies the settlement procedures for index warrants which are exercised prior to expiration. Specifically, the Amendment clarifies that a.m. settlement will be required on valuation date as well as during the last two business days prior to an index warrant's valuation date. As discussed above, the Commission believes that the use of a.m. settlement during this period will help to ameliorate any potential price effects associated with expirations of derivative index products. Accordingly, the Commission believes it is appropriate to approve Amendment No. 5 on an accelerated basis.

Therefore, the Commission believes it is consistent with Sections 6(b)(5) and 19(b)(2) of the Act to approve Amendments No. 1, 2, 3, 4 and 5 to the CBOE's proposal on an accelerated basis.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendments No. 1, 2, 3, 4 and 5. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549. 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 in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, DC. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by September 28, 1995.

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,[52] that the proposed rule change (SR–CBOE–94–34) is approved, as amended, with the portion of the rule change relating to spread margin treatment being approved on a one year pilot program basis, ending August 29, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[53]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95–22108 Filed 9–6–95; 8:45 am]

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[Release No. 34–36171; File No. SR–NASD–55–35]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Date of Implementation of the NASD's Primary Market Maker Standards and the Duration of the Pilot Program for the NASD's Short Sale Rule

August 30, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on August 24, 1995, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. As discussed below, the Commission has also granted accelerated approval of the proposal.

[52] 15 U.S.C. 78s(b)(2) (1988).

[53] 17 CFR 200.30–3(a)(12) (1994).

[1] 15 U.S.C. 78s(b)(1) (1988).

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

Pursuant to Section 19(b)(1) of the Act, the NASD is proposing to delay, from September 6, 1995 to December 1, 1995, the implementation date of the Primary Market Maker standards to be used to determine the eligibility of market makers to an exemption from the NASD's short-sale rule. The NASD also proposes to extend the termination date for the pilot period to June 3, 1996 instead of March 5, 1996. The text of the proposed rule change is as follows (additions are underlined; deletions are bracketed).

RULES OF FAIR PRACTICE

ARTICLE III

Short Sale Rule

Sec. 48

* * * * *

(1)(3) *Until December 1, 1995, t*[T]he term ''qualified market maker [,]'' [for a period of one year after the effective date of this section,] shall mean a registered Nasdaq market maker that has maintained, without interruption, quotations in the subject security for the preceding 20 business days.

* * * * *

For purposes of this subsection, a market maker will be deemed to have maintained quotations without interruption if the market maker is registered in the security and has continued publication of quotations in the security through the Nasdaq system on a continuous basis; provided however, that if a market maker is granted an excused withdrawal pursuant to the requirements of Part VI, Schedule D to the By-Laws, the 20 business day standard will be considered uninterrupted and will be calculated without regard to the period of the excused withdrawal. *Beginning December 1, 1995,* [One year after effectiveness of this section,] the term ''qualified market maker'' shall mean a registered Nasdaq market maker that meets the criteria for a Primary Nasdaq Market Maker as set forth in Article III, Section 49 of the Rules of Fair Practice.

* * * * *

(m) This section shall be in effect until *June 3, 1996* [March 6, 1996].

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 NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any