

As discussed below, the Commission finds that the proposed rule change is consistent with the requirements of the Act. Further, the Commission finds good cause for approving the proposal prior to the 30th day after the date of publication of notice of filing in the **Federal Register**. The Commission believes that accelerated approval of the proposal is appropriate in that it will permit the NASD to provide interested persons adequate notice that implementation of the PMM standards will be delayed until December 1, 1995 and that the expiration of the short sale rule, including the PMM standards, will be extended until June 3, 1996.

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

As discussed in the Original Approval Order, the Commission believed and continues to believe that the imposition for a limited time of a short sale rule and accompanying PMM standards applicable to Nasdaq National Market securities is consistent with the requirements of Sections 15A(b)(6), 15A(b)(9) and 15A(b)(11) of the Act.<sup>5</sup> As discussed below, the Commission believes that delayed implementation of the PMM standards until December 1, 1995 and limited extension of the short sale rule until June 3, 1996 (rather than March 6, 1996) is consistent with the Act and the rules and regulations promulgated thereunder.<sup>6</sup>

Maintaining the current operation of the short sale rule until the NASD has completed and tested the systems necessary to provide market participants adequate notice of a market maker's PPM status will avoid confusion in the marketplace and assure consistency in the application of NASD rules. Moreover, extension of the short sale rule until June 3, 1996 will maintain the

effectiveness of the PMM standards for six months, as envisioned by the Commission's Original Approval Order. As noted in the Original Approval Order, this will provide the Commission and the NASD the opportunity to study the effects of the rule and its exemptions and to determine whether these are practicable and necessary on an ongoing basis, or whether other alternatives would be more appropriate.

#### V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies 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 Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by September 28, 1995.

#### VI. Conclusion

For the reasons stated above, the Commission believes the rule change is consistent with the Act and, therefore, has determined to approve it.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the rule change SR-NASD-95-35 be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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#### Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 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 November 9, 1994, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b) ("Section 19(b)") of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to establish uniform rules for the listing and trading of stock index ("index" or "stock index"), currency ("currency") and currency index ("currency index") warrants (collectively "warrants"). Notice of the proposed rule change appeared in the **Federal Register** on December 20, 1994.<sup>3</sup> One comment letter was received in response to the proposal.<sup>4</sup>

The Exchange subsequently filed Amendment No. 1 ("Amendment No. 1") to the proposal on August 25, 1995. Amendment No. 1 proposes to amend the filing in order to respond to the Comment Letter, the Commission's comments and to conform certain of the Exchange's proposed rules and policies to those filed by other securities markets. This order approves the proposal, as amended.

#### II. Description of the Proposal

The NYSE proposes to establish uniform rules for the listing and trading of stock index, currency and currency index warrants.<sup>5</sup> Paragraphs 703.15 (Foreign Currency Warrants and Currency Index Warrants) and 703.17 (Stock Index Warrants Listing Standards) of the *Listed Company Manual* would be amended to provide uniform listing criteria for index,

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988 & Supp. V 1993).

<sup>2</sup> 17 CFR § 240.19b-4 (1994).

<sup>3</sup> See Securities Exchange Act Release No. 35095 (Dec. 12, 1994), 59 FR 65552.

<sup>4</sup> See Letter from Paul M. Gottlieb, Seward & Kissell, to Jonathan G. Katz, Secretary, Commission, dated January 10, 1995 ("Comment Letter" or "Seward & Kissell Letter").

<sup>5</sup> 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 only be exercised during a specified period before expiration).

<sup>5</sup> 15 U.S.C. 78o-3(b) (6), (9) and (11). Section 15A(b)(6) requires among other things, that the NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. 15 U.S.C. § 78o-3(b)(6). Sections 15A(b) (9) and (11) require that the NASD's rule be designed not to impose any burden on competition not necessary or appropriate in furtherance of the Act, *id.* § 78o-3(b)(9), and to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing and publishing quotations. *Id.* § 78o-3(b)(11). In addition, the Commission believes that the rule change will further the goals of Section 11A in that it will promote efficient and effective market operations and economically efficient execution of investor orders in the best market and assure fair competition between the exchange markets and the OTC market and among brokers and dealers. *Id.* § 78k-1(a)(1)(C).

<sup>6</sup> Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

<sup>7</sup> 17 CFR 200.30-3(a)(12) (1989).

currency and currency index warrants. First, warrant issuers would be expected to exceed minimum issuer listing standards. In particular, the Exchange proposes that issuers be 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.<sup>6</sup>

Second, the proposal requires that each unexercised in-the-money warrant be automatically exercised on either the delisting date (if the issue is not listed upon another organized securities market) or upon expiration. Third, the proposal 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 at expiration of the warrants, as well as the two business days preceding expiration.<sup>7</sup> Fourth, a new paragraph has been added to Para. 703.17 of the *Listed Company Manual* to prohibit "non-U.S. component securities" from constituting more than 20 percent of the weighted value of an index stock group that underlies a stock index warrant. For purposes of this provision, the term "non-U.S. component security" means, the stock, or an American Depositary Receipt on the stock, of a company that is organized outside of the United States, where more than 50 percent of the dollar value of the global trading volume of the security occurs outside of the United States and that are not subject to a comprehensive surveillance agreement with the primary foreign market.<sup>8</sup> Finally, the Exchange proposes to add Rule 414(n), which is designed 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. For domestic index

warrants, this notice must occur by 4:30 p.m. (New York time) on the day that the settlement value for the warrants is determined.<sup>9</sup>

Rule 431 ("Rule 431"), the NYSE margin rule, is being amended to apply the current customer margin requirements for broad based stock index and currency options to stock index, currency and currency index warrants. 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 to 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 a margin level of 100% of the current market value of each such warrant plus a four percent "add-on."<sup>10</sup> The margin required on currency index warrants would be an amount as determined by the Exchange and approved by the Commission.<sup>11</sup> 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 subsections (f)(2)(F)(i), (f)(2)(G)(ii) and (f)(2)(G)(iii) of Rule 431, to the extent that such rules concern spread and straddle positions in warrants, be subject to a one year pilot basis.<sup>12</sup>

<sup>9</sup> See Amendment No. 3.

<sup>10</sup> See Amendment No. 2. 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 26.

<sup>11</sup> See *infra* note 26.

<sup>12</sup> 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.

Paragraph (f)(2)(H)(iv) of Rule 431 would be amended to permit the carrying of "short" option positions against the use of letters of guarantee or (in the case of a call) "escrow receipts," without the need for margin. The amendment proposes to expand that provision to include stock index warrants as well as options. The use of "escrow receipts" to offset a short call option or warrant position would be new to the Exchange's margin rules, which currently only allow the use of letters of guarantee. However, the margin rules of other U.S. options exchanges provide that no margin is required on a short call option where a customer has delivered to the firm carrying the customer's account a satisfactory escrow receipt. Amendment No. 1 would add the escrow receipt concept to the Exchange's margin rules in respect of margin on options, as well as on stock index warrants, and would do so in a way that generally parallels the permissible use of letters of guarantee under the Exchange's margin rules.

Proposed Rule 414(f) 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 721. Furthermore, proposed Rules 414(g)-(k) require that the option rules pertaining to supervision of accounts, suitability, discretionary account trading, customer complaints and communications to customers be applied to transactions in warrants. Finally, prior to trading index, currency or currency index warrants, the Exchange will distribute circulars to its membership providing guidance regarding member firm compliance responsibilities (including suitability recommendations) when handling transactions in warrants.

Proposed Rule 414(c) 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.<sup>13</sup> 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.<sup>14</sup> The rule also gives the Exchange the authority to require the liquidation of a position in stock index warrants that is in excess of

<sup>13</sup> See *infra* note 39.

<sup>14</sup> 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.

<sup>6</sup> See Amendment No. 1. The Exchange amended this provision in response to the Seward & Kissell Letter.

<sup>7</sup> See Amendment No. 1. The Exchange amended its proposal in response to the Seward & Kissell Letter and will require the use of opening prices in calculating index warrant settlement values during the 48 hours prior to expiration. Before then, an issuer may use either opening or closing prices.

<sup>8</sup> See *infra* note 37 and accompanying text.

the position limits set forth in the rule, and Commentary to the rule establishes procedures for allowing limited exceptions to the position limits.

Proposed Rule 414(d) provides for exercise limits on stock index warrants analogous to those found in stock index options and states that such limits are distinct from any exercise limits that may be imposed by the issuers of stock index warrants. Accordingly, no member may exercise a long position in warrants over a five consecutive day period in excess of the permissible position limit.

In order to facilitate its review of compliance with position and exercise limits, the Exchange has proposed Rule 414(c)(v) which 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. For purposes of this rule, the Exchange proposes that long positions in puts be combined with short positions in call warrants, and that short positions in puts be combined with long positions in call warrants.<sup>15</sup> Finally, proposed Rule 414(e) requires that the trading halt provisions of Rule 717 shall be applied to the trading of stock index warrants.

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.<sup>16</sup>

### III. Comments Received

The Commission received one letter in response to its request for comments on the NYSE proposal.<sup>17</sup> The Comment Letter was generally supportive of the

NYSE'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.<sup>18</sup>

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.<sup>19</sup> 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 Letter's comments respecting issuer

<sup>18</sup> 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.

<sup>19</sup> 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 were not to exceed 25% of the issuer's net worth ("25% test).

listings standards, the NYSE amended the filing to add an alternative issuer qualification criteria.<sup>20</sup> 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 NYSE amended its filing to include a provision permitting p.m. settlement for stock index warrants except for a short period before expiration.<sup>21</sup> 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 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

<sup>20</sup> See Amendment No. 1.

<sup>21</sup> See Amendment No. 1.

<sup>15</sup> See Amendment No. 1.

<sup>16</sup> See *infra* note 26.

<sup>17</sup> See *supra* note 4. The Seward & Kissel Letter was submitted on behalf of PaineWebber 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").

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 NYSE 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 NYSE 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 represents the collective investment of a number of persons. The NYSE states that this will conform the handling of warrant accounts to the current practice with respect to listed options accounts.<sup>22</sup>

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 exemptions 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 NYSE 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).<sup>23</sup> 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 NYSE'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 NYSE'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.<sup>24</sup> 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 leveraged 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 customers arising from the derivative products.<sup>25</sup> For the reasons discussed below, the Commission believes the NYSE'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.<sup>26</sup>

#### 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 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.

<sup>25</sup> 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 risks associated with their portfolios.

<sup>26</sup> 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).

<sup>23</sup> 15 U.S.C. 78f(b)(5) (1982).

<sup>24</sup> 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.

<sup>22</sup> See Amendment No. 1.

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 and 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 NYSE'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 expiring warrants as well as during the last two business days prior to valuation date.<sup>27</sup> 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.<sup>28</sup> 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 NYSE 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 the trading in these instruments, in accordance with NYSE Rule 721, and that adequate disclosure of the risks of these products must be made to investors.<sup>29</sup> In addition, the NYSE 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 NYSE had 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 NYSE had 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 currency warrants will be subject to the NYSE'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

<sup>27</sup> Currency and currency index warrants are not limited to a.m. or p.m. settlement.

<sup>28</sup> Foreign stock market based index warrants may utilize p.m. settlement throughout their duration.

<sup>29</sup> Pursuant to NYSE Rule 726, all options approved accounts must receive an ODD, which discusses the characteristic and risks of standardized options.

involving the warrant market and the underlying foreign currencies.<sup>30</sup>

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.<sup>31</sup> 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 NYSE in its surveillance capacity and help it to detect and deter market manipulation and other trading abuses.

Third, the Exchange has 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.).<sup>32</sup> 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<sup>33</sup> in place between an exchange listing or trading a derivative product and the exchange(s)

<sup>30</sup> See Securities Exchange Act Release No. 24555 (June 5, 1987), 52 FR 22570 (June 12, 1987), and Securities 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 26. 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.

<sup>31</sup> 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.

<sup>32</sup> 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.

<sup>33</sup> 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).

trading the stocks underlying the derivative contract that specifically enables the relevant markets to surveil trading in the derivative product and its underlying stocks.<sup>34</sup> 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.<sup>35</sup> In this regard, the NYSE 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<sup>36</sup> 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).<sup>37</sup> 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 NYSE 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 option on those futures. An active over-the-counter market also exists in options, forwards and swaps for foreign

<sup>34</sup> 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.

<sup>35</sup> 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.

<sup>36</sup> See *supra* note 33.

<sup>37</sup> See Securities Exchange Act Release Nos. 31529, 57 FR 57248 (Dec. 3, 1992) and 33555, 59 FR 5619 (Feb. 7, 1994).

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 would 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 that NYSE'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 on a permanent basis the proposed spread margin rules.<sup>38</sup>

<sup>38</sup> 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

Fourth, the NYSE has established reasonable position and exercise limits for stock index warrants, which will serve to minimize potential manipulation and other market impact concerns.<sup>39</sup> 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.<sup>40</sup>

## 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.

SEC. See Amendment No. 1. 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.

<sup>39</sup>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.

<sup>40</sup>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).

The Commission finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register** 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 amendment on an accelerated basis.

Amendment No. 1 proposes to make the following changes to the Index Warrant Filing:

### Changes to Trading Rules

- A definition of "cross currency" would be added to Rule 414(a)(ii).
- The position limit rule (Rule 414(c)(i)) would be amended to provide that, in determining compliance with position limits, "aggregate stock index warrant position" refers to warrants "on the same side of the market".
- A new paragraph 414(c)(v) ("Reports of Index Warrant Positions") would be added to require members and member organizations to report aggregate positions in excess of 100,000 warrants.
- The Index Warrant Filing prescribes the use of opening prices in determining settlement values for all settlement dates. This Amendment No. 1 would amend Paragraph 414(l) ("Settlement Values") to require the use of opening prices in respect of the calculation of settlement values on the day of expiration or on the two business days prior to expiration. Before then, an issuer may use either opening or closing prices in calculating settlement values.
- A new paragraph 414(n) would be added to require the reporting of changes in the number of outstanding warrants due to early warrant exercises.

### Changes to Margin Rules

- A new paragraph would be added to Paragraph (f)(2)(C) of Rule 431 ("Margin Requirements") in order to define "call" and "put" in the currency, currency index and stock index warrant context.
- A new element would be added to the definition of "index group value" (see Paragraph (f)(2)(C) of Rule 431): In calculating the index group value, one

must multiply by the index value (as in the Index Warrant Filing), and divide by any applicable divisor for which the warrant's prospectus may provide (a new addition).

- Paragraph (f)(2)(D)(i) of Rule 431 contains a chart of initial, maintenance and minimum margin requirements. The currency warrant section of that chart would be amended so as to list the margin requirements for specific currencies. The currency index warrant section would be amended to provide that the Exchange will determine currency index warrant margin requirements on a case-by-case basis.

- The Index Warrant Filing proposes to provide margin advantages to certain option and warrant positions (*i.e.*, certain spread and straddle positions) by adding second and third paragraphs to Paragraph (f)(2)(F)(1). This Amendment No. 1 would revise the permissible offset positions and restate those paragraphs to make them easier to read.

- Two paragraphs would be deleted from Paragraph (f)(2)(H). The Index Warrant Filing proposes those paragraphs for the purpose of addressing margin on "short" stock index warrant positions where the holder of the position has hedged by replicating the underlying index with appropriate positions in the component securities. The paragraphs would be replaced by the "letter of guarantee" and "escrow receipt" provisions discussed in the next three bullets.

- Paragraph (f)(2)(H)(iv) (which the Index Warrant Filing proposes to renumber as (f)(2)(H)(v)) of Rule 431 would be amended (although it was not amended in the Index Warrant Filing). That paragraph permits the carrying of "short" option positions against the use of letters of guarantee or (in the case of a call) escrow receipts, without the need for margin. The amendment proposes to expand that provision to include stock index warrants as well as options.

- The use of "escrow receipts" to offset a position carried short would be new to the Exchange's margin rules, which currently only allow the use of letters of guarantee. However, the margin rules of other United States options exchanges provide that no margin is required on a call option where a customer has delivered to the firm carrying the customer's account a satisfactory escrow receipt. Amendment No. 1 would add the escrow receipt concept to the Exchange's margin rules in respect of margin on options, as well as on stock index warrants, and would do so in a way that generally parallels the permissible use of letters of

guarantee under the Exchange's margin rules.

- The definition of two terms that are found in existing paragraph (f)(2)(H)(iv) of Rule 431 would be amended. The changed definitions would apply in the "letter of guarantee" context, as well as in the "escrow receipt" context.

- The definition of "qualified security" would change to "a security listed on a national securities exchange", rather than "a security that meets the listing criteria of the Exchange or of the American Stock Exchange".

- The definition of "cash equivalents" would change to "securities issued or guaranteed by the United States and having a maturity of two years or less", rather than "those instruments referred to in section 220.8(a)(3)(ii) of Regulation T".

The changes to both definitions follow similar changes that the American Stock Exchange has heretofore effected.

- Paragraph (f)(2)(K) of Rule 431 would be amended to specify that the Exchange may specify higher margin for "warrants" (stated generically) if the Exchange deems circumstances to warrant higher margin.

- New Supplementary Material .20 would be added to Rule 431 to specify that the Exchange will subject the spread and straddle margin rules that the Index Warrant Filing proposes to add to paragraphs (f)(2)(F)(i), (f)(2)(G)(ii) and (f)(2)(G)(iii) of Rule 431 to a one-year pilot program. The Exchange would submit to the Commission three months prior to the expiration of the pilot programs a report analyzing the price relationship between listed warrants and options on similar stock indexes.

#### *Changes to Listing Standards*

- The "net worth"/"asset" test applicable to issuers of currency, currency index or stock index warrants would be amended. (See paragraph (a) of Para. 703.15 of the *Listed Company Manual* in respect of currency and currency index warrants and paragraph (a) of Para. 703.17 of the *Listed Company Manual* in respect of stock index warrants.) Under the new test, an issuer may satisfy the test if it has minimum tangible net worth in excess of \$250 million. Alternatively, as in the Index Warrant Filing, the issuer may have minimum tangible net worth in excess of \$150 million if its total currency, currency index and stock index warrants do not exceed 25 percent of its net worth.

- Para. 703.15 and Para. 703.17 of the *Listed Company Manual* would limit the term of currency, currency index

and stock index warrants to between one and five years.

- A new paragraph would be added to Para. 703.17 of the *Listed Company Manual* to prohibit "non-United States component securities" that are not subject to comprehensive surveillance agreements from constituting more than 20 percent of the weighted value of an index stock group that underlies a stock index warrant.

Finally, the Index Warrant Filing proposes to introduce Rule 414(h) ("Suitability"), which would limit trading by customers in currency, currency index or stock index warrants to options-approved accounts. In the case of an institutional account or an investment club or other collective account, the Exchange would allow a member organization to accept the representation of a registered investment adviser as to the eligibility of the institution or collective investment group, even if the managed account is lacking the underlying documentation.

As mentioned above, because 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, the Commission believes it is appropriate to approve Amendment No. 1 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 Amendment No. 1 to the NYSE's proposal on an accelerated basis.

#### **VI. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., 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 NW., 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,<sup>41</sup> that the proposed rule change (SR-NYSE-94-41) 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.<sup>42</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-36166; File No. SR-PSE-94-28]

### **Self-Regulatory Organizations; Pacific Stock Exchange, Inc.; Order Approving Proposed Rule Change 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 22, 1994, the Pacific Stock Exchange, Inc. ("PSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b) ("Section 19(b)") of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to establish uniform rules for the listing and trading of stock index ("index" or "stock index"), currency ("currency") and currency index ("currency index") warrants (collectively "warrants"). Notice of the proposed rule change appeared in the **Federal Register** on December 20, 1994.<sup>3</sup> One comment letter was received in response to the proposal.<sup>4</sup>

The Exchange subsequently filed five Amendments to the proposal.<sup>5</sup>

<sup>41</sup> 15 U.S.C. 78s(b)(2) (1988).

<sup>42</sup> 17 CFR § 200.30-3(a)(12) (1994).

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988 & Supp. V 1993).

<sup>2</sup> 17 CFR 240.19b-4 (1994).

<sup>3</sup> See Securities Exchange Act Release No. 35088 (Dec. 12, 1994), 59 FR 65554.

<sup>4</sup> See Letter from Paul M. Gottlieb, Seward & Kissel, to Jonathan G. Katz, Secretary, Commission, dated January 10, 1995 ("Comment Letter" or "Seward & Kissel Letter").

<sup>5</sup> See Letters from Michael Pierson, PSE, to Stephen M. Youhn, SEC, dated March 24, 1995