

[Release No. 34-35304; International Series Release No. 779; File No. SR-CBOE-94-20]

**Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to the Listing of Options and Long-Term Options on the CBOE Emerging Asian Markets Index and Long-Term Options on a Reduced-Value CBOE Emerging Asian Markets Index**

January 31, 1995.

**I. Introduction**

On June 30, 1994, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to provide for the listing and trading of index options on the CBOE Emerging Asian Markets Index ("Asian Markets Index" or "Index"). The Exchange filed Amendment No. 1 to the proposed rule change on August 18, 1994.<sup>3</sup> Notice of the proposal, as amended, appeared in the **Federal Register** on August 26, 1994.<sup>4</sup> The Exchange subsequently filed Amendment No. 2 to the proposed rule change on January 26, 1995.<sup>5</sup> No comment letters were received on the proposed rule change. This order approves the Exchange's proposal, as amended.

**II. Description of Proposal**

**A. General**

The CBOE proposes to list for trading options on the Asian Markets Index, a new securities index developed by the

CBOE. The Asian Markets Index is composed of the securities issued by 15 closed-end mutual funds<sup>6</sup> that are traded on the New York Stock Exchange ("NYSE") and that invest in the stocks of firms in emerging Asian economies, excluding Japan.<sup>7</sup> The CBOE also proposes to list either long-term options on the full-value Index or long-term options on a reduced-value Index that will be computed at one-tenth of the value of the Asian Markets Index ("Asian Markets LEAPS" or "Index LEAPS").<sup>8</sup> Asian Markets LEAPS will trade independent of and in addition to regular Index options traded on the Exchange,<sup>9</sup> however, as discussed below, for purposes of position and exercise limits, positions in Index LEAPS and regular Index options will be aggregated.

**B. Composition of the Index**

The Index was designed by the Exchange and is based on the securities issued by 15 closed-end mutual funds that invest in the stocks of firms in emerging Asian economies, excluding Japan. The shares of each of the closed-end funds contained in the Index trade in the U.S. on the NYSE. The Index is price-weighted and will be calculated on a real-time basis using last sale prices of the shares of the closed-end funds comprising the Index.

As of the close of trading on January 4, 1995, the Index was valued at 122.35.

<sup>6</sup> *Id.*

<sup>7</sup> The components of the Index are the: Asia Pacific Fund; Asia Tigers Fund Inc.; China Fund Inc.; Greater China Fund Inc.; Jardine Fleming China Region Fund Inc.; Morgan Stanley India Fund; Jakarta Growth Fund Inc.; Korea Fund Inc.; Korea Equity Fund Inc.; Malaysia Fund Inc.; First Philippine Fund Inc.; Singapore Fund Inc.; ROC Taiwan Fund; Taiwan Fund Inc.; and Thai Fund Inc.

<sup>8</sup> LEAPS is an acronym for Long-Term Equity Anticipation Securities. LEAPS are long-term index option series that expire from 12 to 36 months from their date of issuance. See CBOE Rule 24.9(b)(1). The Commission notes that the Exchange has submitted a proposed rule change to allow the CBOE to list index LEAPS that expire up to 60 months from their date of issuance and to allow up to 10 expiration months to be outstanding at any one time. See Securities Exchange Act Release No. 35278 (January 25, 1995).

<sup>9</sup> According to the CBOE, the Asian Markets Index represents a segment of the U.S. equity market that is not currently represented in the derivative markets and as such, the CBOE concludes, should offer investors a low-cost means of achieving diversification of their portfolios toward or away from emerging Asian market securities. The CBOE believes the Index will provide retail and institutional investors with a means of benefitting from their forecasts of the performance of emerging Asian market securities. The Exchange further believes that options on the Index also can be utilized by portfolio managers and investors as a means of hedging the risks of investing in emerging Asian market securities either directly or through mutual funds that invest primarily in Asian market securities.

Also as of that date the market capitalizations of the individual closed-end fund securities in the Index ranged from a high of \$628.65 million to a low of \$46.36 million, with the mean and median being \$205.05 million and \$172.65 million, respectively. The total market capitalization of the securities in the Index on that date was \$3.08 billion. The price per share of the closed-end fund securities comprising the Index on January 4, 1995, ranged from a high of \$28.13 to a low of \$8.63, with an average price per share of \$14.99.<sup>10</sup>

The average daily trading volume of the shares of the closed-end funds contained in the Index, for the period from July 1, 1994, through December 31, 1994, ranged from a high of 118,056 shares per day to a low of 9,984 shares per day. As of January 4, 1995, no single closed-end fund security contained in the Index accounted for more than 12.51% of the Index's total value and the percentage weighting of the five largest issues in the Index accounted for 48.80% of the Index's value. The percentage weighting of the lowest weighted securities issued by a closed-end fund contained in the Index was 3.84% of the value of the Index and the percentage weighting of the five smallest closed-end fund securities contained in the Index accounted for 22.29% of the Index's value.<sup>11</sup> Based on the aggregate holdings of the mutual funds represented in the Index, as disclosed in the most recent semiannual reports of the component closed-end funds filed with the Commission prior to August 16, 1994, the CBOE represents that securities from no single country accounted for more than 16.25% (Hong Kong) nor less than 4.50% (China) of the weight of the Index. Based on the same semiannual reports, by aggregating the holdings of the closed-end funds comprising the Index, the CBOE represents that no single security held by one or more of the component mutual funds accounted for more than 1.25% of the weight of the Index.<sup>12</sup> Finally, more than 10 emerging Asian countries are represented through the holdings of the component funds comprising the Index.<sup>13</sup>

<sup>10</sup> See Amendment No. 2, *supra* note 5.

<sup>11</sup> *Id.*

<sup>12</sup> For example, four of the 15 component funds held shares of China Light & Power based on these semiannual reports. By aggregating the positions of these four mutual funds, China Light & Power accounted for 0.73% of weight of the Index. See Letter from Eileen Smith, Director, Product Development, Research Department, CBOE, to Brad Ritter, Senior Counsel, OMS Division, Commission, dated August 16, 1994 ("August 16 Letter").

<sup>13</sup> *Id.*

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

<sup>2</sup> 17 CFR 240.19b-4 (1992).

<sup>3</sup> In Amendment No. 1, the Exchange proposed to treat the Asian Markets Index as a narrow-based index for purposes of margin, position limits, the exercise limits. Pursuant to CBOE Rule 24.4A, the position limits for the Index will initially be set at 10,500 contracts. See Letter from Eileen Smith, Director, Product Development, Research Department, CBOE, to Brad Ritter, Senior Counsel, Office of Market Supervision ("OMS"), Division of Market Regulation ("Division"), Commission, dated August 18, 1994.

<sup>4</sup> See Securities Exchange Act Release No. 34553 (August 19, 1994), 59 FR 44205 (August 26, 1994).

<sup>5</sup> In Amendment No. 2, the Exchange proposed: (1) to reduce the number of components in the Index from 16 to 15; and (2) several amendments, as discussed more fully herein, regarding the maintenance criteria for the Index. See Letter from Joseph Levin, Vice President, Research Department, CBOE, to Brad Ritter, Senior Counsel, OMS, Division, Commission, dated January 16, 1995 ("Amendment No. 2").

### C. Maintenance

The Index will be maintained by the CBOE. The CBOE may change the composition of the Index at any time, subject to compliance with the maintenance criteria discussed below, to reflect the conditions in the emerging Asian securities markets, excluding Japan. If it becomes necessary to replace the securities issued by a closed-end fund contained in the Index, the Exchange represents that every effort will be made to add only replacement securities issued by closed-end mutual funds that preserve the character of the Index and that are listed on either the American Stock Exchange ("Amex") or the NYSE, or that are Nasdaq National Market ("Nasdaq/NM") securities.<sup>14</sup> In considering securities of closed-end mutual funds to be added to the Index, the CBOE will take into account the capitalization, liquidity, volatility, and name recognition of the particular closed-end funds and the securities issued by those mutual funds. Further, a closed-end fund represented in the Index may be replaced in the event of certain events, such as a change in the investment objectives of the mutual fund. The Exchange will most likely maintain securities representing 15 closed-end funds in the Index.<sup>15</sup> In addition, in choosing securities issued by closed-end funds as replacements for or additions to the Index, the CBOE will not make a composition change that would result in less than 75% of the weight of the Index or 75% of the number of closed-end funds represented in the Index satisfying the listing criteria for standardized options trading set forth in CBOE Rule 5.3, Interpretation and Policy .01 (for mutual fund securities that are not then the subject of standardized options trading)<sup>16</sup> and CBOE Rule 5.4, Interpretation and Policy .01 (for mutual fund securities that are then the subject of standardized

options trading).<sup>17</sup> Additionally, at least twice each year the CBOE will review the Index to ensure that not less than 75% of the weight of the Index and 75% of the number of closed-end funds represented in the Index continue to satisfy the criteria for standardized options trading set forth in CBOE Rule 5.3, Interpretation and Policy .01 (for mutual fund securities that are not then the subject of standardized options trading) and CBOE Rule 5.4, Interpretation and Policy .01 (for mutual fund securities that are then the subject of standardized options trading).

Moreover, at least twice each year, based on the most recent Commission filings by the closed-end funds represented in the Index, the CBOE will review the holdings of each of the closed-end funds and will promptly notify the Commission if it becomes aware that: (1) any security held by one or more mutual funds represented in the Index, in aggregate, accounts for more than 5% of the weight of the Index; or (2) securities from any one country held by one or more mutual funds represented in the Index, in aggregate, account for more than 25% of the weight of the Index.

Finally, the CBOE will promptly notify the Commission staff at any time that the CBOE determines that the securities of a closed-end fund contained in the Index account for more than 15% of the weight of the Index if: (1) the shares of the mutual fund do not satisfy the listing eligibility requirements in CBOE Rule 5.3, Interpretation and Policy .01 (if the mutual fund does not then have standardized options trading on its shares); or (2) the shares of the mutual fund do not satisfy the maintenance eligibility requirements in CBOE Rule 5.4, Interpretation and Policy .01 (if the mutual fund has standardized options trading on its shares).<sup>18</sup>

The CBOE will promptly notify the Commission staff at any time that the CBOE determines that either the Index or the securities issued by the closed-end funds comprising the Index fail to satisfy any of the above maintenance criteria. Further, in such an event, the

Exchange will not open for trading any additional series of Index options or Index LEAPS unless the Exchange determines that such failure is not significant, and the Commission staff affirmatively concurs in that determination, or unless the Commission specifically approves the continued listing of that class of Index options or Index LEAPS pursuant to a proposal filed in accordance with Section 19(b)(2) of the Act.<sup>19</sup>

### D. Applicability of CBOE Rules Regarding Index Options

Except as modified by this order, the rules in Chapter XXIV of the CBOE Rules will be applicable to Index options and full-value and reduced-value Index LEAPS. In accordance with Chapter XXIV of CBOE's rules, the Index will be treated as a narrow-based index for purposes of applicable position and exercise limits, policies regarding trading halts and suspensions, and margin treatment.<sup>20</sup>

### E. Calculation of the Index

The CBOE Emerging Asian Markets Index is a price-weighted index and reflects changes in the prices of the closed-end mutual fund securities comprising the Index relative to the Index's base date of December 31, 1991. Specifically, the Index value is calculated by adding the prices of the mutual fund securities comprising the Index and then dividing this summation by a divisor that is equal to the number of the closed-end funds represented in the Index in order to obtain an average price. To maintain the continuity of the Index, the divisor will be adjusted to reflect non-market changes in the prices of the closed-end fund securities comprising the Index as well as changes in the composition of the Index. Changes that may result in divisor adjustments include, but are not limited to, certain rights issuances.

The Index will be calculated continuously and will be disseminated to the Options Price Reporting Authority ("OPRA") every fifteen seconds by the CBOE, based on the last-sale prices of the closed-end fund securities comprising the Index.<sup>21</sup> OPRA, in turn, will disseminate the

<sup>14</sup> Additionally, the CBOE will be required to ensure that each closed-end fund security comprising the Index is a "reported security" as defined in Rule 11Aa3-1 of the Act. See Amendment No. 2, *supra* note 5.

<sup>15</sup> If the CBOE determines to increase the number of components to greater than 20 or to decrease the number of components to less than 10, the Exchange will be required to submit a rule filing pursuant to Section 19(b) of the Act. *Id.*

<sup>16</sup> *Id.* The CBOE's options listing standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 7,000,000 shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume in the U.S. must have been at least 2.4 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$7.50 for a majority of the business days during the preceding three calendar months. See CBOE rule 5.3, Interpretation and Policy .01.

<sup>17</sup> See Amendment No. 2, *supra* note 5. The CBOE's options maintenance standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 6,300,000 shares; (2) there must be a minimum of 1,600 stockholders; (3) trading volume in the U.S. must have been at least 1.8 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$5.00 for a majority of the business days during the preceding six calendar months. See CBOE Rule 5.3, Interpretation and Policy .01.

<sup>18</sup> See Amendment No. 2, *supra* note 5.

<sup>19</sup> *Id.*

<sup>20</sup> See *infra* Section II.H.

<sup>21</sup> For purposes of dissemination of the Index value, if the shares of a mutual fund included in the Index have not opened for trading, the CBOE will use the closing value of those shares on the prior trading day when calculating the value of the Index, until the shares of the mutual fund open for trading.

Index value to other financial vendors such as Reuters, Telerate, and Quotron.

The Index value for purposes of settling outstanding regular Index options and full-value and reduced-value Index LEAPS contracts upon expiration will be calculated based upon the regular way opening sale prices for each of the closed-end fund securities comprising the Index in their primary market on the last trading day prior to expiration.<sup>22</sup> In the event that a closed-end fund security traded as a Nasdaq/NM security is added to the Index, the first reported sale prices for those shares will be used for determining a settlement value. Once the shares of all of the mutual funds represented in the Index have opened for trading, the value of the Index will be determined and that value will be used as the final settlement value for expiring Index options contracts, including full-value and reduced-value Index LEAPS. If any of the closed-end fund securities contained in the Index do not open for trading on the last trading day before expiration, then the prior trading day's (*i.e.*, normally Thursday's) last sale price will be used in the Index value calculation. In this regard, before deciding to use Thursday's closing value for a closed-end fund security contained in the Index for purposes of determining the settlement value of the Index, the CBOE will wait until the end of the trading day on Expiration Friday (as defined herein).

#### F. Contract Specifications

The proposed options on the Index will be cash-settled, European-style options.<sup>23</sup> Standard options trading hours (8:30 a.m. to 3:15 p.m.<sup>24</sup> Central Standard time) will apply to the contracts. The Index multiplier will be 100. The strike price interval will be \$5.00 for full-value Index options with a duration of one year or less to expiration.<sup>25</sup> In addition, pursuant to CBOE rule 24.9, there may be up to six expiration months outstanding at any given time. Specifically, there may be up to three expiration months from the March, June, September, and December cycle plus up to three additional near-

term months so that the two nearest term months will always be available. As described in more detail below, the Exchange also intends to list several Index LEAPS series that expire from 12 to 36 months from the date of issuance.<sup>26</sup>

Lastly, the options on the Index will expire on the Saturday following the third Friday of the expiration month ("Expiration Friday"). Accordingly, because options on the Index will settle based upon opening prices of the closed-end fund securities comprising the Index on the last trading day before expiration (normally Expiration Friday), the last trading day for an expiring Index option series will normally be the second to the last business day before expiration (normally a Thursday).

#### G. Listing of Long-Term Options on the Full-Value or Reduced-Value Asian Markets Index

The proposal provides that the Exchange may list long-term Index options that expire from 12 to 36 months from listing based on the full-value Index or a reduced-value Index that will be computed at one-tenth of the full-value Asian Markets Index.<sup>27</sup> Existing Exchange requirements applicable to full-value Index options will apply to full-value and reduced-value Index LEAPS.<sup>28</sup> The current and closing Index value for reduced-value Asian Markets LEAPS will be computed by dividing the value of the full-value Index by 10 and rounding the resulting figure to the nearest one-hundredth. For example, an Index value of 122.36 would be 12.24 for the reduced-value Index LEAPS and an Index value of 122.34 would be 12.23 for the reduced-value Index LEAPS. The reduced-value Index LEAPS will also be European-style and will be subject to the same rules that govern the trading of Index options, including sales practice rules, margin requirements and floor trading procedures. Pursuant to CBOE Rule 24.9, the strike price interval for the reduced-value Index LEAPS will be no less than \$2.50 instead of \$5.00.

#### H. Position and Exercise Limits, Margin Requirements, and Trading Halts

Exchange rules governing margin requirements,<sup>29</sup> position and exercise

limits,<sup>30</sup> and trading halt procedures<sup>31</sup> that are applicable to the trading of narrow-based index options will apply to options traded on the Index. The proposal further provides that, for purposes of determining whether given positions in full-value and reduced-value Index LEAPS comply with applicable position and exercise limits, positions in full-value and reduced-value Index LEAPS will be aggregated with positions in the regular Index options. For these purposes, ten reduced-value contracts will equal one full-value contract.

#### I. Surveillance

Surveillance procedures currently used to monitor trading in each of the Exchange's other index options will also be used to monitor trading in regular Index options and in full-value and reduced-value Index LEAPS. These procedures include complete access to trading activity in the shares of the mutual funds comprising the Index. Further, the Intermarket Surveillance Group Agreement will be applicable to the trading of options on the Index.<sup>32</sup>

#### III. Findings and Conclusions

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the national securities exchange and, in particular, the

Index value; and (2) for long options positions, 100% of the options premium paid.

<sup>30</sup> Pursuant to CBOE Rules 24.4A and 24.5, respectively, the position and exercise limits for the Index options will be 10,500 contracts, unless the Exchange determines, pursuant to such rules, that a lower limit is warranted.

<sup>31</sup> Pursuant to CBOE Rule 24.7, the trading on the CBOE of Index options and Index LEAPS may be halted or suspended whenever trading in underlying mutual fund shares whose weighted value represents more than 20% of the Index value are halted or suspended.

<sup>32</sup> The Intermarket Surveillance Group ("ISG") was formed on July 14, 1983 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 amendments made thereafter, was signed by ISG members on January 29, 1990. See Second Amendment to the Intermarket Surveillance Group Agreement, January 29, 1990. The members of the ISG are: the Amex; the Boston Stock Exchange, Inc.; the CBOE, the Chicago Stock Exchange, Inc.; the National Association of Securities Dealers, Inc. ("NASD"); the NYSE, the Pacific Stock Exchange, Inc.; and the Philadelphia Stock Exchange, Inc. Because of potential opportunities for trading abuses involving stock index futures, stock options, and the underlying stock and the need for greater sharing of surveillance information for these potential intermarket trading abuses, the major stock index futures exchanges (*e.g.*, the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

<sup>22</sup> As noted above, the current primary market for each of the closed-end fund securities comprising the Index is the NYSE.

<sup>23</sup> A European-style option can be exercised only during a specified period before the option expires.

<sup>24</sup> Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and Brad Ritter, Senior Counsel, OMS, Division, Commission, on January 27, 1995.

<sup>25</sup> For a description of the strike price intervals for reduced-value Index options and long-term Index options, See *infra*, Section II.G.

<sup>26</sup> See *supra* note 8.

<sup>27</sup> *Id.*

<sup>28</sup> See CBOE Rule 24.9(b).

<sup>29</sup> Pursuant to CBOE Rule 24.11, the margin requirements for the Index options will be: (1) for short options positions, 100% of the current market value of the options contract plus 20% of the underlying aggregate Index value, less any out-of-the-money amount, with a minimum requirement of the options premium plus 10% of the underlying

requirements of Section 6(b)(5).<sup>33</sup> Specifically, the Commission finds that the trading of Asian Markets Index options, including full-value and reduced-value Index LEAPs, will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with a means of hedging exposure to market risk associated with emerging Asian market securities.<sup>34</sup>

The trading of options on the Asian Markets Index, including full-value and reduced-value Index LEAPs, however, raises several issues related to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the CBOE has adequately addressed these issues.

#### A. Index Design and Structure

The Commission finds that it is appropriate to treat the Asian Markets Index as a narrow-based index under CBOE rules for purposes of applicable position and exercise limits, trading halt and suspension procedures, and margin treatment. Although the closed-end funds represented in the Index, in aggregate, hold in excess of 180 individual Asian market securities,<sup>35</sup> the Asian Markets Index is composed of securities representing only 15 closed-end mutual funds.<sup>36</sup> Accordingly, in light of the limited number of closed-end fund securities contained in the Index, the Commission believes it is proper to treat the Asian Markets Index as narrow-based for the regulatory purposes noted above.

The Commission also finds that the large capitalizations, liquid markets, and relative weightings of the closed-end fund securities comprising the Index significantly minimize the potential for manipulation of the Index.

<sup>33</sup> 15 U.S.C. 78f(b)(5)(1988).

<sup>34</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option proposal upon a finding that the introduction of such new 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. In this regard, the trading of listed Index options and full-value and reduced-value Index LEAPs will provide investors with a hedging vehicle that should reflect the overall movement of Asian market securities, excluding Japanese securities, represented through the holdings of closed-end mutual funds traded in the U.S.

<sup>35</sup> See August 16, Letter, *supra* note 12.

<sup>36</sup> The reduced-value Asian Markets Index, which consists of the same component mutual fund components as the Index and is calculated by dividing the Index value by ten, is identical to the Asian Markets Index.

First, the overwhelming majority of the closed-end fund securities comprising the Index are actively traded, with an average daily trading volume for all such mutual fund shares for the period from July 1, 1994 through December 31, 1994, of approximately 53,568 shares per day. Second, the market capitalizations of the closed-end fund securities in the Index are large, ranging from a high of \$628.65 million to a low of \$46.36 million as of January 4, 1995, with the mean and median being \$205.05 million and \$172.65 million, respectively. Third, although the Index is composed of securities representing only 15 closed-end mutual funds, no particular security or group of closed-end fund securities dominates the Index. Specifically, as of January 4, 1995, no closed-end fund security contained in the Index accounted for more than 12.51% of the Index's total value and the percentage weighting of the five largest closed-end fund securities in the Index accounted for 48.80% of the Index's value.

Fourth, the proposed maintenance criteria will serve to ensure that: (1) the Index remains comprised substantially of closed-end mutual funds that are highly capitalized and that have liquid markets for their issued securities; and (2) the Index is not dominated by any one mutual fund security that does not satisfy the Exchange's options listing criteria, any one security held by one or more of the mutual funds represented in the Index, or securities from any one country held by one or more of the mutual funds represented in the Index. Specifically, in considering changes to the composition of the Index, 75% of the weight of the Index and 75% of the number of closed-end mutual funds represented in the Index must comply with the listing criteria for standardized options trading set forth in CBOE Rule 5.3, Interpretation and Policy .01 (for mutual fund securities that are not then the subject of standardized options trading) and CBOE Rule 5.4, Interpretation and Policy .01 (for mutual fund securities that are then the subject of standardized options trading).<sup>37</sup> Additionally, the CBOE is required to review the composition of the Index at least semiannually to ensure that the Index continues to meet these "75%" requirements.

Further, at least semiannually, based on the most recent Commission filings

<sup>37</sup> Additionally, mutual fund securities contained in the Index must be "reported" securities and must be traded on the Amex or the NYSE or must be Nasdaq/NM securities. The CBOE is also limited in the number of mutual funds that can be represented in the Index without having to obtain Commission approval. See *supra* notes 14 and 15.

by the closed-end funds represented in the Index, the CBOE will review the holdings of each closed-end fund and will promptly notify the Commission if: (1) any security held by one or more of the closed-end funds represented in the Index, in aggregate, accounts for more than 5% of the weight of the Index; or (2) securities from any one country held by one or more of the closed-end funds represented in the Index, in aggregate, account for more than 25% of the weight of the Index. Similarly, the CBOE will promptly notify the Commission staff at any time that it determines that the shares of a closed-end fund contained in the Index account for more than 15% of the weight of the Index if the shares of the mutual fund do not satisfy the listing eligibility requirements in CBOE's rules.<sup>38</sup>

Finally, the CBOE will promptly notify the Commission staff at any time that it determines that either the Index or the shares of one or more of the closed-end funds comprising the Index fail to satisfy any of the above maintenance criteria. In such an event, the Exchange will not open for trading any additional series of Index options or LEAPs unless the Exchange determines that such failure is not significant, and the Commission staff affirmatively concurs in that determination, or unless the Commission specifically approves the continued listing of that class of Index options or Index LEAPs pursuant to a proposal filed in accordance with Section 19(b)(2) of the Act.

For the above reasons, the Commission believes that these criteria minimize the potential for manipulation of the Index and eliminate domination concerns.

#### B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as Asian Markets Index options, including full-value and reduced-value Asian Markets LEAPs, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) the special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the

<sup>38</sup> See *supra* notes 16 and 17.

Index options and Index LEAPS will be subject to the same regulatory regime as the other standardized index options currently traded on the CBOE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in Asian Markets Index options and full-value and reduced-value Asian Markets Index LEAPS.

### C. Surveillance

The Commission notes that predominantly because of the lack of relevant market information sharing agreements, the shares of only one of the closed-end funds contained in the Index (Asia Pacific Fund) are eligible for standardized options trading.<sup>39</sup> The Commission believes, however, that based on the maintenance criteria discussed above, the CBOE has addressed the concerns that the Commission expressed in approving the listing of options on individual country funds.<sup>40</sup> These maintenance criteria, among other things, ensure that the Index will not become a surrogate for trading options on either the closed-end mutual funds represented in the Index or individual Asian market securities held by those component mutual funds for which standardized options could not otherwise be traded and minimize the potential for manipulation of the value of the Index.<sup>41</sup>

Second, in approving the listing of options on individual country funds, the Commission determined that if a fund is "diversified," as defined in the Investment Advisers Act of 1940 ("Advisers Act"),<sup>42</sup> and holds securities from five or more countries, a surveillance sharing agreement is not required between the Exchange and the primary foreign markets for the securities held by the closed-end fund. In that case, it was determined that the portfolio of such a closed-end fund would be significantly diverse so as to reduce the likelihood that the price of

the securities issued by the closed-end fund could be manipulated. Even though the shares of only one of the closed-end funds contained in the Index is classified as "diversified," the Commission believes that by combining the securities of these mutual funds together in the Index, the Index, as a whole, replicates essentially a "diversified" fund. Specifically, the Index consists of securities representing 15 closed-end mutual funds with those mutual funds holding positions, in aggregate, in more than 180 different stocks from more than 10 emerging Asian markets.<sup>43</sup> The Commission believes, therefore, that the Index as a whole achieves the diversity of holds that the Commission found to be sufficient in the Country Fund Approval Order to minimize the Commission's concerns about potential manipulation. As a result, for the reasons stated herein and in the Country Fund Approval Order,<sup>44</sup> the Commission believes that the lack of market surveillance sharing agreements does not raise substantial regulatory concerns.

Third, because the Index is composed solely of the securities issued by closed-end mutual funds, the Commission's concerns regarding potential manipulation of the Index are further reduced. As discussed in the Country Fund Approval Order, in contrast to other foreign securities products, international closed-end mutual funds hold portfolios of securities chosen by portfolio managers.<sup>45</sup> Although the composition of the portfolio of each mutual fund represented in the Index is published on a semiannual basis, the securities held by each mutual fund represented in the Index can be changed at any time at the discretion of the portfolio managers, as long as their investment decisions are consistent with the stated investment objectives and policies of the particular closed-end fund. For these reasons, the Commission believes that it generally would be difficult for someone to use options on the Index to attempt a manipulation of the market for any particular security issued by a closed-end fund represented in the Index or to attempt a manipulation of the Index through a manipulation of the shares of the mutual funds comprising the Index.

The Commission notes that generally the only people who could attempt such a manipulation would be people who have access to "inside" information about the composition of the portfolio of

a closed-end fund and the trading activities of the mutual fund's portfolio manager. The Advisers Act, and the rules promulgated thereunder, contain provisions designed to detect and deter certain advisory employees and affiliates from trading in any securities based on "inside" information about the investment decisions of a closed-end fund. Rule 204-2(a)(12) under the Advisers Act requires an investment adviser to make and keep accurate records of every transaction in a security in which the investment adviser or any advisory representative has a beneficial interest. Accordingly, the Commission believes that the Advisers Act gives it the authority to review the trading activities of anyone who is likely to have access to the information necessary to use options on the Index to attempt a manipulation of the relevant markets.

Finally, even though the CBOE does not in this case have market information sharing agreements with each of the relevant foreign markets, the CBOE, NYSE, Amex, and NASD are all members of the ISG, which provides for the exchange of all necessary surveillance information regarding the trading of the mutual fund securities comprising the Index.<sup>46</sup> The Commission believes that this arrangement ensures the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the Index options and full-value and reduced-value Index LEAPS less readily susceptible to manipulation.<sup>47</sup>

### D. Market Impact

The Commission believes that the listing and trading on the CBOE of Asian Markets Index options, including full-value and reduced-value Index LEAPS, will not adversely impact the markets for the securities issued by the closed-end funds represented in the Index.<sup>48</sup> First, as described above, the securities of no one closed-end fund or group of closed-end funds represented in the Index dominates the weight of the Index. Second, the maintenance criteria for the Index ensure that: (1) the Index will be substantially comprised of closed-end fund securities that satisfy

<sup>39</sup> Options on the securities issued by international funds are eligible for standardized options trading where those securities meet or exceed the Exchange's established uniform options listing standards (see *supra* note 16) and (1) the Exchange has a market information sharing agreement with the primary home exchange on which each of the foreign securities comprising the fund's portfolio trade, (2) the fund is classified as a diversified fund, as that term is defined by Section 5(b) of the Investment Company Act, 15 U.S.C. § 80a-5(b), and the fund's portfolio is composed of securities from five or more countries, or (3) the listing of a particular international fund option is specifically approved by the Commission. See Securities Exchange Act Release No. 33068 (October 19, 1993), 58 FR 55093 (October 25, 1993) ("Country Fund Approval Order").

<sup>40</sup> *Id.*

<sup>41</sup> See *supra* Section III.A.

<sup>42</sup> 15 U.S.C. 80b-1 *et. seq.* (1988).

<sup>43</sup> See August 15 Letter, *supra* note 12.

<sup>44</sup> See Country Fund Approval Order, *supra* note 39.

<sup>45</sup> *Id.*

<sup>46</sup> See *supra* note 32.

<sup>47</sup> See, e.g., Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992) (order approving the listing of Index options and Index LEAPS on the CBOE Biotech Index).

<sup>48</sup> In addition, the CBOE has represented that the CBOE and the OPRA have the necessary systems capacity to support those new series of Index options that would result from the introduction of Index options and Index LEAPS. See Memorandum from Joe Corrigan, Executive Director, OPRA, to Scott Lyden, CBOE, dated June 27, 1994.

the Exchange's listing standards for standardized options trading; and (2) no individual security held by one or more of the mutual funds represented in the Index and no individual country represented by those holdings will dominate the Index.<sup>49</sup> Third, because the securities issued by each of the closed-end funds comprising the Index must be "reported securities" as defined in Rule 11Aa3-1 of the Act, the securities issued by these closed-end funds generally will be actively-traded, highly-capitalized securities. Fourth, the 10,500 contract position and exercise limits applicable to Index options and Index LEAPS will serve to minimize potential manipulation and market impact concerns.

Lastly, the Commission believes that settling expiring Asian Markets Index options, including full-value and reduced-value Index LEAPS, based on the opening prices of the closed-end fund securities comprising the Index is consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than closing prices may help reduce adverse effects on markets for the closed-end fund securities underlying options on the Index.<sup>50</sup>

The Commission finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, Amendment No. 2 provides objective maintenance criteria which, for the reasons stated above, should minimize the potential for manipulation of the Index and the closed-end mutual fund securities comprising the Index. Further, as discussed above, the Commission believes that these maintenance criteria significantly strengthen the customer protection and surveillance aspects of the proposal, as originally proposed.<sup>51</sup> Moreover, the Commission believes that reducing the number of component funds in the Index by one is not a material change that raises regulatory concerns not already addressed by the proposal. Accordingly, the Commission believes it is consistent with Sections 6(b)(5) and 19(b)(2) of the Act to approve Amendment No. 2 to the proposed rule change on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and

arguments concerning Amendment No. 2. 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 at 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 SR-CBOE-94-20 and should be submitted by March 1, 1995.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>52</sup> that the proposed rule change (SR-CBOE-94-20), as amended, is approved.<sup>53</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>54</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35307; File No. SR-CBOE-95-03]

#### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to Restrictions on the Exercise on Index Options

January 31, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on January 18, 1995, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange

<sup>49</sup> 15 U.S.C 78s(b)(2) (1988).

<sup>53</sup> The Commission notes that prior to listing Index options or Index LEAPS, the CBOE will be required to review the then most recent semiannual reports filed with the Commission by each of the closed-end funds represented in the Index to ensure that the closed-end fund securities comprising the Index, as well as the holdings of each of the closed-end funds represented in the Index, satisfy, at the time of listing, the listing criteria discussed above.

<sup>54</sup> 17 CFR 200.30-3(a)(12) (1994).

Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend its Rule 4.16 to limit the time period during which restrictions on the exercise of index options may be in effect, making Rule 4.16 consistent with CBOE Regulatory Circular RG91-11, dated January 14, 1991. Rule 4.16 would be amended to substitute the words "business day" for the words "trading day," thereby making Rule 4.16 consistent with CBOE's stated policy as set forth in Regulatory Circular RG91-11. The text of the proposed rule change is available at the Office of the Secretary, the CBOE, and at the Commission.

#### 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 CBOE included statements concerning the purpose of and basis for the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Section (A), (B), and (C) below, of the most significant aspects of such statements.

##### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to revise Rule 4.16 to make it consistent with CBOE's stated policy regarding when restrictions on the exercise of index options may be in effect, as set forth in Regulatory Circular RG91-11. The Exchange represents that it promulgated the policies regarding exercise restrictions in Regulatory Circular RG91-11 to implement a coordinated approach to which all of the options exchanges had agreed. Regulatory Circular RG91-11 provides, in part, that, except during "the last business day prior to expiration, the (American Stock Exchange, CBOE, New York Stock Exchange, Pacific Stock Exchange, and the Philadelphia Stock Exchange) intend to prohibit exercises of cash settled index options during any time when trading in such options are

<sup>49</sup> See *supra* Section III.A.

<sup>50</sup> See Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

<sup>51</sup> See *supra* Section III.A.