

F. Effective Date of the Proposed Rule Change

The rule change will apply to filings that become effective with the Commission on or after January 1, 1996. Thus, offerings filed with the Corporate Financing Department of the NASD that have not become effective with the Commission prior to January 1, 1996 will be required to comply with the rule change, regardless of whether the Corporate Financing Department has previously issued an opinion that it has no objections to the terms and arrangements.

III. Comments

The Commission received one comment⁹ in response to its publication of notice in the Federal Register. In addition, the NASD received four comments¹⁰ in response to its solicitation of comment from its membership.¹¹ Generally, all the commenters opposed the proposal.

All the significant arguments raised by the commenters were summarized and responded to by the NASD in its proposal and were included in the Commission's notice of publication and solicitation of comment. Generally, commenters expressed concern that the NASD is unnecessarily interfering with the contractual relationship between the issuer and the underwriter, who are free to negotiate a termination of the right if they so desire. For example, one commenter argued that the NASD should limit its role to general review of the level of underwriting compensation and not regulation of the "method, manner, nature, timing and other matters relat[ed] to [underwriting] compensation."¹²

IV. Discussion

The Commission believes that the rule change is consistent with the requirements of Section 15A of the Act and the rules and regulations thereunder applicable to the NASD and, therefore, has determined to approve the proposal. Section 15A requires that the

⁹ Letter from Perry L. Taylor, Jr., Chairman, Capital Markets Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC (Aug. 29, 1995).

¹⁰ Letters from Stuart N. Kingoff, Associate Corporate Counsel, Lew Lieberbaum and Co., Inc. (Nov. 18, 1994); Lawrence B. Fisher, Kelley Drye and Warren (Nov. 30, 1994); and Bachner, Tally, Polevoy and Misher (Nov. 30, 1994), to Joan C. Conley, Secretary, NASD, and letter from Richard P. Woltman, President, Spelman & Co., Inc., to Jonathan G. Katz, Secretary, SEC (Nov. 16, 1994).

¹¹ NASD Notice to Members 94-82 (Oct. 1994).

¹² Letter from Perry L. Taylor, Jr., Chairman, Capital Markets Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC (Aug. 29, 1995).

rules of the NASD, among other things, be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.¹³

The Commission believes this proposal strikes an appropriate balance by allowing underwriters and issuers to continue to negotiate compensation agreements tailored to the needs of the parties while protecting issuers and investors from excessive and unfair payment arrangement under these agreements. The Commission agrees that issuers and underwriters should be allowed to enter into compensation arrangements which include compensation for terminating a right of first refusal. The Commission believes, however, that the NASD's proposal to place certain limits on the terms of these provisions will further the protection of issuers and investors and, thus, the public interest.

V. Conclusion

For the reasons discussed, the Commission finds that the rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD, in a particular, Section 15A(b)(6).

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change SR-NASD-95-29 be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95-24796 Filed 10-4-95; 8:45 am]

BILLING CODE 8010-01-M

[Release No. 34-36296; File No. SR-NASD-95-37]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendments No. 1, 2 and 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Listing and Trading of Broad-Based Index Warrants on The Nasdaq Stock Market

September 28, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is

¹³ 15 U.S.C. 78o-3(b)(6) (1988).

¹⁴ 17 CFR 200.30-3(a)(12) (1994).

hereby given that on August 28, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The NASD filed Amendment No. 1 ("Amendment No. 1") to the proposed rule change on September 22, 1995.¹ On September 27, 1995, the NASD filed Amendment No. 2 ("Amendment No. 2") to the proposal.² On September 28, 1995, the NASD filed Amendment No. 3 ("Amendment No. 3") to the proposal.³ This Order approves the proposed rule change, as amended, on an accelerated basis and also solicits comments on the proposed rule change, as amended, from interested persons.

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

The NASD is proposing several changes to its rules to accommodate the trading of the index warrants based on broad-based indexes on The Nasdaq Stock Market ("Nasdaq"). The proposed changes augment and enhance the Association's regulatory requirements applicable to index warrants which were previously approved by the Commission in June 1992.⁴ In addition, unlike the current regulatory structure for index warrants whereby the Commission separately approves each type of index warrant for trading (*i.e.*, Hong Kong Index warrants or Nikkei Index warrants), the proposed changes streamline the approval process for index warrants by providing that an index is eligible to underlie an index warrant traded through the facilities of the Nasdaq system once the Commission has approved such index to underlie an index warrant or option.

Specifically, the NASD proposes the following rule amendments. First, Section 2(c)(2) of Part III of Schedule D

¹ Letter from Joan C. Conley, Corporate Secretary, NASD, to Michael Walinskas, SEC, dated September 22, 1995. Amendment No. 1, which is superseded, in part, by Amendment No. 2, raises position limits on the Russell 2000 Index and S&P MidCap 400 Index ("MidCap Index"). It also establishes that Section 13, Liquidation of Positions, will apply to short sales in warrants.

² Letter from T. Grant Callery, Vice President and General Counsel, NASD, to Michael Walinskas, SEC, dated September 27, 1995. Amendment No. 2 reduces the position limits on the MidCap Index to 7.5 million warrants.

³ Letter from Joan C. Conley, Corporate Secretary, NASD, to Michael Walinskas, SEC, dated September 28, 1995. Amendment No. 3 clarifies the settlement methodology to be utilized for index warrants.

⁴ See Securities Exchange Act Release No. 30773 (June 3, 1992), 57 FR 24835 (June 11, 1992) ("Index Warrant Approval Order").

to the NASD's By-Laws is revised to add new listing standards applicable to the issuers of index warrants. Previously, issuers of index warrants were required to have assets in excess of \$100 million. Under the revised standards:

(1) issuers would 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 the issuer has not issued warrants such that the aggregate original issue price of all of the issuer's stock index, currency index, and currency warrant offerings (combined with offerings by its affiliates) listed on Nasdaq or a national securities exchange exceeds 25% of the issuer's net worth;

(2) the term of the index warrants must provide that unexercised in-the-money warrants will be automatically exercised on either the delisting date (if the issue is not listed on a national securities exchange) or upon expiration;

(3) for warrant offerings where U.S. stocks constitute 25 percent or more of the index value, issuers must use the opening prices ("a.m. settlement") of the U.S. stocks to determine the index warrant settlement value for expiring warrants on the final determination of settlement value date ("valuation date") as well as during the two business days immediately preceding valuation date⁵;

(4) in instances where the stock index underlying a warrant is comprised in whole or in part with securities traded outside the United States, the foreign country securities or American Depositary Receipts ("ADRs") thereon that (i) are not subject to a comprehensive surveillance agreement, and (ii) have less than 50% of their global trading volume in dollar value within the U.S., shall not, in the aggregate, represent more than 20% of the weight of the index, unless such index is otherwise approved for warrant or option trading; and

(5) to assist in the surveillance of index warrant trading, as a condition of listing on Nasdaq, issuers would be required to notify the NASD of any early warrant exercises by 4:30 p.m., Eastern Standard Time, on the day the settlement value for the warrants is determined.

Second, the proposal adds a new Schedule J to the NASD's By-Laws. This schedule consolidates all of the regulatory requirements applicable to the conduct of accounts, the execution of transactions, and the handling of orders in index warrants listed on Nasdaq and exchange-listed stock index warrants, currency index warrants, and

currency warrants by members who are not members of the exchange on which the warrant is listed or traded. In particular, Schedule J provides that: (1) All customer accounts trading index warrants, currency index warrants, and currency warrants must be approved to trade options;⁶ (2) the options suitability rule applies to all recommendations to customers involving the purchase or sale of index warrants, currency index warrants, and currency warrants; and (3) the options rules contained in Article III, Section 33(b) of the NASD's Rules of Fair Practice regarding discretionary accounts, the supervision of accounts, customer complaints are applicable to index warrants, currency index warrants, and currency warrants. In addition, Schedule J provides that the NASD's rules governing options communications with the public shall apply to communications with the public concerning index, currency, and currency index warrants. To assist NASD members in complying with the regulatory requirements applicable to index warrants, currency index warrants, and currency warrants, the NASD proposes to distribute a Notice-to-Members providing guidance regarding member firm compliance responsibilities when handling transactions in warrants.

In addition, Schedule J provides for position limits, exercise limits, and reporting requirements applicable to index warrants. The position limits are consolidated position limits, meaning that index warrants on the same index on the same side of the market must be aggregated for position limit purposes. Specifically, for index warrants other than index warrants based on the MidCap Index, the position limit is 15 million warrants, provided the initial offering price of the warrants was at or below \$10. For index warrants based on the MidCap Index, the position limit is 7.5 million warrants, provided the initial offering price of the warrants was at or below \$10.⁷ The proposal also contains a provision that equalizes

positions in index warrants that initially were priced above \$10 with those that were priced at or below \$10. In particular, positions will be equalized by dividing the original issue price of the index warrants priced above \$10 by ten and multiplying this number by the size of the index warrant position. For example, if an investor held 100,000 Nasdaq 100 Index warrants priced initially at \$20, the size of this position for position limit purposes would be 200,000, or 100,000 times 20 divided by 10.

The exercise limits provide that no investor or group of investors acting in concert may, within five consecutive business days, exercise more index warrants on the same index on the same side of the market than the applicable index warrant position limit. The reporting requirements provide that positions of 100,000 or more index warrants on the same index on the same side of the market must be reported to the Association. Schedule J also contains provisions setting forth the NASD's authority to mandate the liquidation of index warrant positions in excess of applicable position limits.⁸ In addition, proposed Schedule J provides that the NASD may halt or suspend trading in an index warrant if it concludes that such action is appropriate in the interests of a fair and orderly market and the protection of investors.⁹

Third, the NASD proposes to add a new Section 3(f)(10) to Article III, Section 30 of the NASD Rules of Fair Practice governing the margin treatment for index warrants, currency index warrants, and currency warrants. Specifically, these new requirements, provide that the initial and maintenance requirements for long positions in index warrants shall be 100% of the full purchase price of the warrants. For short positions in index warrants, the margin requirement is 100% of the current market value of the warrant plus 15% of the current value of the underlying index. The margin requirements for short positions can be decreased to the extent that they are out-of-the-money, however, the minimum requirement for each such warrant shall not be less than the current value of the warrant plus 10% of the current index value.

⁸ See Amendment No. 1.

⁹ Among the factors that may be considered by the NASD are the following: (1) Trading has been halted or suspended in underlying stocks whose weighted value represents 20% or more of the index value; (2) the current calculation of the index derived from the current market prices of the stocks is not available; and (3) other unusual conditions or circumstances detrimental to the maintenance of a fair and orderly market are present.

⁵ See Amendment No. 3.

⁷ See Amendment No. 2.

⁶ In this connection, the NASD will permit NASD members to accept the representation of an investment adviser registered under the Investment Advisers Act of 1940 concerning the eligibility status of certain customers to engage in warrant trading even if the underlying documentation relating to the managed account is not provided to the member. The NASD's position would apply to the managed accounts of an institutional customer or where the investment adviser account represents the collective investment of a number of persons (e.g., an investment club account). Permitting member firms to accept the representation of an investment adviser in these instances will conform the handling of warrant accounts to the current practice for options accounts.

Short sales of currency warrants will follow the margin requirements currently applicable to standardized currency options. Specifically, the NASD 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 percent of the current market value of each such warrant plus a four percent "add-on."¹⁰ The required margin can be decreased to the extent that the warrant is out-of-the-money, however, the minimum requirement for each such warrant must not be less than the current value of the warrant plus .75% (.0075) of the value of the underlying currency (or such other percentage as specified by the national securities exchange listing the warrant and approved by the Commission). The margin required on currency index warrants would be an amount as determined by the national securities exchange listing the warrant and approved by the Commission.

The NASD also proposes that its index warrant, currency index warrant, and currency warrant margin requirements be permitted offset treatment for spread and straddle positions. In this regard, the NASD proposes that index, currency, and currency index warrants may be offset with either warrants or OCC-issued options on the same index, currency, or currency index, respectively, in the same manner that standardized index and currency options may be offset with other standardized index and currency options. The proposed rules governing the margin treatment for spreads and straddles involving index, currency, and currency index warrants are proposed to be implemented on a one-year pilot basis. The NASD also proposes to allow market participants to use escrow receipts to cover a short call position in broad-based stock index warrants. Specifically, no margin is required for a short position in an index call warrant where the customer promptly delivers an escrow receipt, issued by a bank or trust company, certifying that the issuer holds for the account of the customer (1) cash, (2) cash equivalents, (3) one or more qualified equity securities, or (4) a combination thereof.

Fourth, the proposal makes two minor amendments to the NASD's rules that serve to clarify the Association's rules

¹⁰ Warrants on the Canadian Dollar would be subject to a one percent "add-on." The "add-on" required on any other foreign currency would be such other percentage as specified by the national securities exchange listing the warrant and approved by the Commission on a case-by-case basis.

regarding index warrants. First, Section 19 of Part I of Schedule D to the NASD's By-Laws is amended to clarify that the term Nasdaq National Market System security includes all index warrants traded through Nasdaq. Second, the proposal replaces language currently contained in a policy of the NASD's Board of Governors issued under Article III, Section 2 of the Rule of Fair Practice with a cross-reference to new Schedule J. This change is made to eliminate duplicative and potentially confusing language in the NASD's rules. The text of the proposed rule change is available at the Office of the Secretary of the NASD 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 NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

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

The NASD is submitting this proposed rule change to enhance the NASD's regulatory scheme governing index warrants to ensure that, among other things, investors in index warrants traded on Nasdaq are adequately protected and that the trading of index warrants on Nasdaq does not have any adverse market impacts.¹¹ To this end, the NASD has developed a new Schedule J to its By-Laws that consolidates all of the relevant rules, regulations, practices and procedures applicable to index warrants trading on Nasdaq and exchange-listed stock index warrants, currency index warrants, and currency warrants traded by members who are not members of the exchange on which the warrant is listed or traded. The NASD also proposes to impose

¹¹ Due to the current definition of "security" in Section 3(a)(10) of the Act, 15 U.S.C. 78c(a)(10), the NASD, unlike the national securities exchanges, does not have authority to list issuances of currency and currency index warrants on Nasdaq. The NASD is proposing rules, however, that will apply to transactions in currency and currency index warrants entered into by NASD members (or customers thereof) who are not members of the exchange on which the currency or currency index warrant is listed or traded.

more stringent standards on the issuers of index warrants, as well as certain requirements as to the terms of the index warrants themselves. Under the proposal, all exchange-traded index warrants and foreign currency warrants presently outstanding will be grandfathered from these provisions. Even though there currently are no index warrants listed on Nasdaq, NASD rules provide that issuers of Nasdaq-listed index warrants are required to have assets in excess of \$100 million and members are obligated to comply with the NASD's options rules governing suitability, account opening, discretionary accounts, and account supervision when handling customer orders in index warrants. The NASD's current proposal expands these requirements in the following ways.

First, because index warrants are derivative in nature and closely resemble index options, the NASD believes it is appropriate to apply to index warrants, currency index warrants, and currency warrants the same or similar safeguards for customer protection that are applicable to exchange-traded standardized options. Accordingly, Schedule J is patterned after the NASD's options rules contained in Article III, Section 33 of the NASD's Rules of Fair Practice. In particular, proposed Sections 3 through 9 of Schedule J impose on index warrants, currency index warrants, and currency warrants the options rules governing account opening, suitability, discretionary accounts, supervision of accounts, customer complaints and communications with the public and customers. These provisions will ensure that members are adequately monitoring their customer accounts trading index, currency, and currency index warrants and that only customers with an understanding of these warrants and the financial capacity to bear the risks attendant thereto will be permitted to trade these instruments based on their broker's recommendation. In addition, as discussed above, the proposed margin rules for index, currency, and currency index warrants are comparable to those applicable to standardized index and currency options. Accordingly, the NASD believes that the special concerns attendant to the secondary trading of index warrants on Nasdaq have been adequately addressed by the NASD.

Second, the NASD proposes to increase the listing standards applicable to issuers of index warrants to ensure that only substantial companies capable of meeting their warrant obligations are able to list index warrants on Nasdaq. In particular, by switching from a \$100

million gross assets standard to a standard where issuers will 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 the issuer has not issued warrants such that the aggregate original issue price of all of the issuer's stock index, currency index, and currency warrant offerings (combined with offerings by its affiliates) listed on Nasdaq or a national securities exchange exceeds 25% of the issuer's net worth, the NASD believes that issuers will be better able to satisfy their warrant obligations.

Third, the NASD proposes to implement several safeguards designed to ameliorate any potential adverse market impacts resulting from the trading of index warrants. Specifically, the listing standards provide that only broad-based indexes can underlie index warrants traded through the facilities of the Nasdaq system. Sections 10 and 11 of Schedule J provide for consolidated position and exercise limits for index warrants on the same index on the same side of the market and Section 12 imposes a reporting requirement for positions of 100,000 warrants on the same index on the same side of the market. In addition, the listing standards provide that the settlement values for stock index warrants overlying indexes with U.S. components greater than 25 percent of the value of the index must be determined with reference to the opening prices of the U.S. securities in such indexes on valuation date as well as during the two business days immediately preceding valuation date.¹² The NASD's proposal also provides for the notification to the NASD of early exercises of stock index warrants and disclosure of certain trading activities by issuers in response to such early exercises.

The proposal also imposes requirements with respect to the percentage weighting of a multi-country or foreign stock index that must be subject to an effective surveillance sharing arrangement and establishes procedures governing the halting or suspension of trading in an index warrant. The NASD believes that these requirements will facilitate the orderly unwinding of index warrant positions and related cash market positions upon the expiration of index warrants and enhance the ability of the NASD to surveil trading in index warrants and related markets.

Lastly, the NASD proposes to add Section 2(c)(2)(K) of Part III to Schedule

D of the NASD's By-Laws that will streamline the approval process for index warrants. This section provides that once a broad-based index has been approved by the SEC to underlie an index warrant or option, the index is then eligible to underlie an index warrant traded on Nasdaq without further Commission review or approval, provided the NASD has obtained all the surveillance sharing agreements mandated by the Commission. The NASD believes that this self-effectuating listing process for index warrants will promote market efficiency and allow the NASD to better meet the demands of investors in the Nasdaq marketplace. At the same time, the NASD does not believe that this approval process will compromise the protection of investors in any way because the Commission will already have approved the underlying index to underlie an index option or warrant.

Accordingly, the NASD believes the proposed rule change is consistent with Section 15A(b)(6) of the Act. Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulation, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and in general to protect investors and the public interest. Listing index warrants on Nasdaq will also facilitate members and investors desiring to trade index warrants in a dealer environment. In addition, the sales practice, margin, and position and exercise limit rules, among others, that will be applicable to index, currency, and currency index warrants will serve to protect investors and promote the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The NASD has requested that the proposed rule change given accelerated effectiveness pursuant to Section 19(b)(2) of the Act in view of the Commission's previous approval of substantially identical rule changes submitted by the other SROs.¹³ These other proposals were subject to the full notice and comment period and, in fact, were modified partly in response to a comment letter received on the proposals on behalf of several large broker-dealers.¹⁴ The NASD also notes that the Commission has approved amendments to every other SRO's stock index warrant proposal on an accelerated basis. In addition, the NASD notes that a number of issuers, including Nasdaq listed companies, have expressed an interest in listing index warrants on Nasdaq.

Accordingly, because the NASD's proposed regulatory structure for index warrants mirrors standards already approved by the Commission for other SROs, the NASD believes no regulatory purpose would be served by delaying the ability of Nasdaq to list index warrants. Similarly, the NASD believes that investors in The Nasdaq Stock Market should be afforded the opportunity to trade index warrants. Therefore, the NASD believes that failure to grant accelerated effectiveness of the proposed rule change would result in an unfair burden on competition and regulatory confusion in that the margin and sales practice rules applicable to index and currency warrants will not be uniform among U.S. securities markets. In fact, absent accelerated approval, customers of NASD members who are not members of an exchange will be subject to one regulatory regime for warrants while customers of members who are exchange members will be subject to another regime.

¹³ On August 29, 1995, the Commission approved uniform listing and trading guidelines for stock index, currency and currency index warrants for the New York Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, American Stock Exchange and Chicago Board Options Exchange. See Securities Exchange Act Release Nos. 36165, 36166, 36167, 36168 and 36169 (Aug. 29, 1995), respectively.

¹⁴ See Letter from Paul M. Gottlieb, Seward & Kissel, to Jonathan G. Katz, Secretary, Commission, dated January 10, 1995 ("Comment Letter" or "Seward & Kissel Letter"). 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.

¹² See Amendment No. 3.

IV. 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 a national securities exchange, and, in particular, the requirements of Section 15A(b)(6).¹⁵ Specifically, the Commission finds that the NASD's proposal to establish uniform listing standards for broad-based stock index warrants, as well as standards applicable to the trading of stock index, currency and currency index warrants by NASD members (or customers thereof) who are not members of the exchange on which the warrant is listed or traded, strikes a reasonable balance between the Commission's mandates under Section 15A(b)(6) 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 NASD's proposed listing standards for warrants are consistent with the Section 15A(b)(6) requirements that rules of a registered securities association 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 NASD's proposed generic listing standards for broadbased stock index warrants set forth a regulatory framework for the listing of such products.¹⁶ Generally, listing standards serve as a means for an exchange or securities association 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 or securities association to monitor the status and trading characteristics of that issue to ensure that it continues to meet the exchange's or securities association'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 negative market impact. In addition, these standards should address the special risks to customers arising from the derivative products.¹⁷ For the reasons discussed below, the Commission believes the NASD's proposal will provide it with significant flexibility to list stock index warrants on NASDAQ, without compromising the effectiveness of the NASD's listing standards or regulatory program for such products.¹⁸

A. Issuer Listing Standards and Product Design

As a general matter, the Commission believes that the trading of warrants on a stock index permits investors to participate in the price movements of the underlying securities, and allows investors holding positions in some or all of such securities to hedge the risks associated with their portfolios. The Commission further believes that trading warrants on a stock index provides investors with an important trading and hedging mechanism that is designed to reflect accurately the overall movement of the component securities.

Warrants, unlike standardized options, however, do not have a clearing house 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 NASD's proposed issuer listing standards that require an issuer to have either: (a) a minimum tangible net worth of \$250

¹⁷ 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.

¹⁸ See *supra* note 11.

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.

The NASD'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 of expiring warrants on valuation date ("valuation date") as well as during the last two business days prior to valuation date. 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, the use of p.m. settlement except on valuation date, and during the last two business days prior to 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 designating their products.¹⁹

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 NASD 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

¹⁹ Foreign stock market based index warrants may utilize p.m. settlement throughout their duration.

¹⁵ 15 U.S.C. 78o-3(b)(6) (1988).

¹⁶ 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.

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 NASD has proposed to apply its options customer protection rules to warrants. In particular, the Commission notes that warrants may only be sold to options approved accounts capable of evaluating and bearing the risks associated with trading in these instruments, and that adequate disclosure of the risks of these products must be made to investors.²⁰ In addition, the NASD 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 NASD has addressed adequately several of the potential customer protection concerns that could arise from the options-like nature of warrants.

The ODD, which all options approved accounts must receive, generally explains the characteristics and risks of standardized options products. Although many of the risks to the holder of an index warrant and option are substantially similar, however, because warrants are issuer-based products, some of the risks, such as the lack of a clearinghouse guarantee and certain terms for index warrants, are different. The NASD has adequately addressed this issue by proposing to distribute a circular to its members that will call attention to the specific risks associated with stock index 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, which should ensure that certain information about the participating issuance and issuer is publicly available. The Commission believes that the combined

²⁰ Pursuant to Article III, Section 33(b)(16) of the Rules of Fair Practice, all options approved accounts must receive an ODD, which discusses the characteristics and risks of standardized options.

approach of making available general derivative product information (the ODD), product specific information (the NASD circular), and issuer specific information (the prospectus) should provide an effective disclosure mechanism for these products.

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 NASD has developed adequate surveillance procedures for the trading of index and currency warrants. First, the NASD 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.²¹ Among these enhanced surveillance procedures, the Commission notes that issuers will be required to report to the NASD 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 NASD in its surveillance capacity and help it to detect and deter market manipulation and other trading abuses.

Second, the NASD 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.).²² 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 agreement²³ in place between

²¹ In addition, the Commission notes that issuers will be required to report to the NASD certain trades (as specified in the NASD's surveillance procedures) to unwind a warrant hedge that are effected as a result of the early exercise of domestic index warrants. This will enable the NASD to monitor the unwinding activity to determine if it was effected in a manner that violates NASD or Commission rules.

²² 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.

²³ The Commission believes that a surveillance sharing agreement should provide the parties with the ability to obtain information necessary to detect

an exchange listing or trading a derivative product and the exchange(s) trading the stocks underlying the derivative contract that specifically enables the relevant markets to surveil trading in the derivative product and its underlying stocks.²⁴ 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.²⁵ In this regard, the NASD 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 NASD has in place an effective surveillance agreement²⁶ 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).²⁷ 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 NASD has no surveillance sharing agreement.

D. Market Impact

The Commission believes that the listing and trading of index warrants will not adversely affect the U.S. securities markets. First, with respect to index warrants, the Commission notes that warrants may only be established upon indexes the Commission has previously approved as broad-based in the context of index options or warrant

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 purchasers for securities. *See e.g.*, Securities Exchange Act Release No. 31529 (Nov. 27, 1992).

²⁴ The ability to obtain relevant surveillance information, including, among other things, the identity of the purchasers and sellers of securities, is an essential and necessary component of a comprehensive surveillance sharing agreement.

²⁵ In the context of domestic index warrants, the Commission notes that the U.S. exchanges and the NASD 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*.

²⁶ *See supra* note 23.

²⁷ *See Securities Exchange Act Release Nos. 31529, 57 FR 57248 (Dec. 3, 1992) and 33555, 59 FR 5619 (Feb. 7, 1994).*

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 indexes will adversely impact the underlying component securities. In addition, because index warrants are issued by various individual issuers who set their own terms, it is likely that expirations among similar index products will be varied, thereby reducing the likelihood that unwinding hedge activities would adversely affect the underlying cash market. Finally, as discussed above, the Commission believes the NASD'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.

Second, the NASD 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 NASD 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.²⁸

Third, the NASD has established reasonable position and exercise limits for stock index warrants, which will serve to minimize potential manipulation and other market impact concerns.

V. Conclusion

The Commission believes that the adoption of these uniform listing and trading standards for broad-based index warrants will provide an appropriate

²⁸ The Commission notes that the margin levels for currency index warrants will be set at a level determined by the NASD and approved by the SEC. 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.

regulatory framework.²⁹ These standards will also benefit the NASD 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 that has not been previously approved by the Commission for warrant or options trading. 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.

Finally, the Commission finds good cause for approving the proposed rule change and Amendments No. 1, 2 and 3 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register in order to allow the NASD to begin listing index warrants without delay. As discussed above, the proposal is substantially identical to those submitted by the other SROs.³⁰ These other index warrant proposals were subject to the full notice and comment period and, as discussed above, were modified in response to the Seward & Kissell Letter. Furthermore, Amendment No. 1 to the proposal ensures that NASD members do not accept and/or execute an order to sell short any index warrants from any person that is the subject of an NASD order to liquidate a position in excess of applicable position limits. The Commission notes that this change also comports with rules currently in effect at other SROs applicable to the liquidation of index warrant positions in excess of applicable position limit rules. Amendment No. 2 to the proposal reduces the position limits on the MidCap Index to 7.5 million warrants. The Commission notes that this number is consistent with the level approved for

²⁹ As noted above, the NASD does not have the authority to list currency or currency index warrant issuances. See *supra* note 11. Nevertheless, the regulatory framework adopted herein as also applicable to stock index, currency and currency index warrants which are traded by NASD members (or customers thereof) who are not members of the exchange on which the warrant is listed or traded.

³⁰ See *supra* note 13.

the American Stock Exchange. Accordingly, the amendment does not raise any new or unique regulatory issues. Finally, Amendment No. 3 clarifies that opening price settlement will be utilized for warrants that are valued on valuation date or on either of the two business days preceding valuation date. The Commission notes that this change brings the NASD's proposal into conformity with those of the other exchanges and, therefore, does not believe the amendment raises any new or unique regulatory issues. For these reasons, the Commission believes it is consistent with Sections 15A(b)(6)³¹ and 19(b)(2)³² of the Act to approve the proposed rule change and Amendments No. 1, 2 and 3 to the proposal on an accelerated basis.

VI. 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 Section, 450 Fifth Street, N.W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by October 26, 1995.

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,³³ that the proposed rule change (SR-NASD-95-37) 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, effective beginning September 28, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁴

³¹ 15 U.S.C. § 78o-3(b)(6) (1988).

³² 15 U.S.C. § 78s(b)(2) (1988).

³³ 15 U.S.C. § 78s(b)(2) (1988).

³⁴ 17 CFR § 200.30-3(a)(12) (1994).

Jonathan G. Katz,

Secretary.

[FR Doc. 95-24794 Filed 10-4-95; 8:45 am]

BILLING CODE 8010-01-M

[Release No. 34-36292; File No. SR-NASD-95-43]

Self-Regulatory Organizations; Notice and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Interim Extension of the OTC Bulletin Board® Service Through June 30, 1996

September 28, 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 September 28, 1995 the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items 1, and II, below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is simultaneously approving the proposal.

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

On June 1, 1990, the NASD, through a subsidiary corporation, initiated operation of the OTC Bulletin Board Service ("OTCBB Service" or "Service") in accord with the Commission approval of File No. SR-NASD-88-19, as amended.¹ The OTCBB Service provides a real-time quotation medium that NASD member firms can elect to use to enter, update, and retrieve quotation information (including unpriced indications of interest) for securities traded over-the-counter that are not listed on The Nasdaq Stock MarketSM nor on a registered national securities exchange (collectively referred to as "OTC Equities").² Essentially, the Service supports NASD members' market making in OTC Equities through authorized Nasdaq Workstation® units. Real-time access to quotation information captured in the Service is available to subscribers of

¹ Securities Exchange Act Release No. 27975 (May 1, 1990), 55 FR 19124.

² With the Commission's approval of File No. SR-NASD-93-24, the universe of securities eligible for quotation in the OTCBB now includes certain equities listed on regional stock exchanges that do not qualify for dissemination of transaction reports via the facilities of the Consolidated Tape Association.

Level 2/3 Nasdaq service as well as subscribers of vendor-sponsored services that now carry OTCBB Service data. The Service is currently operating under an interim approval that expires on September 28, 1995.³

The NASD hereby files this proposed rule change, pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder, to obtain authorization for an interim extension of the Service through June 30, 1996. During this interval, there will be no material change in the OTCBB Service's operational features, absent Commission approval of a corresponding Rule 19b-4 filing.

II. Self-Regulatory Organizations' Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

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

The purpose of this filing is to ensure continuity in the operation of the OTCBB Service while the Commission considers an earlier NASD rule filing (File No. SR-NASD-92-7) that requested permanent approval of the Service.⁴ For the month ending August, 1995, the Service reflected the market making positions of 382 NASD member firms displaying quotations/indications of interest in approximately 5,344 OTC Equities.

During the proposed extension, unregistered foreign securities and American Depositary Receipts (collectively, "Foreign Equity Securities") will remain subject to the twice-daily, update limitation that traces back to the Commission's original approval of the OTCBB Service's operation. As a result, all priced bids/offers displayed in the Service for unregistered Foreign Equity Securities will remain indicative. During the period of the extension, the NASD may

³ Securities Exchange Act Release No. 35918 (June 29, 1995), 60 FR 35443, (July 7, 1995).

⁴ Securities Exchange Act Release No. 30766 (June 1, 1992), 57 FR 24281.

allow member firms to publish such priced bids/offers on any Foreign Equity Security that otherwise qualifies for inclusion in the OTCBB service.

In conjunction with the launch of the Service in 1990, the NASD implemented a filing requirement (under Section 4 of Schedule H to the NASD By-Laws) and review procedures to verify member firms' compliance with Rule 15c2-11 under the Act. During the proposed extension, this review process will continue to be an important component of the NASD's self-regulatory oversight of broker-dealers' market making in OTC Equities. The NASD also expects to work closely with the Commission staff in developing further enhancements to the Service to fulfill the market structure requirements mandated by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Reform Act"), particularly Section 17B of the Act.⁵ The NASD notes that implementation of the Reform Act entails Commission rulemaking in several areas, including the development of mechanisms for gathering and disseminating reliable quotation/transaction information for "penny stocks".

* * * * *

The NASD believes that this proposed rule change is consistent with Sections 11A(a)(1), 15A(b)(6) and (11), and 17B of the Act. Section 11A(a)(1) sets forth the Congressional findings and policy goals respecting operational enhancements to the securities markets. Basically, the Congress found that new data processing and communications techniques should be applied to improve the efficiency of market operations, broaden the distribution of market information, and foster competition among market participants. Section 15A(b)(6) requires, among other things, that the NASD's rules promote just and equitable principles of trade, facilitate securities transactions, and protect public investors. Subsection (11) thereunder authorizes the NASD to adopt rules governing the form and content of quotations for securities traded over-the-counter for the purposes of producing fair and informative quotations, preventing misleading

⁵ On November 24, 1992, the NASD filed an application with the Commission for interim designation of the Service as an automated quotation system for penny stocks, pursuant to Section 17B(b) of the Act. On December 30, 1992, the Commission granted Qualifying Electronic Quotation System ("QEQS") status for the Service for purposes of certain penny stock rules that became effective on January 1, 1993. On August 26, 1993, the Commission granted the NASD's request for an extension of QEQS status until such time as the OTCBB meets the statutory requirements of Section 17B(b)(2).