prices of index component securities may help to reduce adverse effects on markets for such securities.[16]

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[17] that the proposed rule change (SR–Amex–96–03), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[18]

Jonathan G. Katz,

Secretary.

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[Release No. 34–37008; Filed No. SR–Amex–95–53]

Self-Regulatory Organizations; American Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Thereto by the American Stock Exchange, Inc., Relating to Options on the Morgan Stanley Healthcare Product Companies Index, the Morgan Stanley Healthcare Providers Index and the Morgan Stanley Healthcare Payors Index

March 21, 1996.

I. Introduction

On December 19, 1995, the American Stock Exchange, Inc. (''Amex'' or ''Exchange'') submitted to the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to provide for the listing and trading of index options on three new indexes developed by Morgan Stanley & Co. Incorporated (''Morgan Stanley'') relating to three different subsectors within the healthcare sector: the Morgan Stanley Healthcare Providers Index (''Providers Index''); the Morgan Stanley Healthcare Payors Index (''Payors Index''); and the Morgan Stanley Healthcare Product Companies Index (''Product Companies Index'') (collectively the ''Indexes''). On January 2, 1996, the Amex filed Amendment No. 1 to its proposal.[3] Notice of the proposed rule change and Amendment No. 1 appeared in the Federal Register on January 23, 1996.[4] No comment letters were received on the proposed rule change. On March 20, 1996, the Exchange filed Amendment No. 2.[5] This order approves the Amex's proposal as amended.

II. Description of Proposal

A. General

The Amex proposes to trade standardized options on the Indexes, each of which is comprised of stocks that are traded on the Amex, the New York Stock Exchange, Inc. (''NYSE''), or are National Market securities traded through Nasdaq. In addition, the Amex proposes to amend Amex Rule 902C(d) to include the Amex proposes to amend Amex Rule 902C(d) to include the Indexes in the disclaimer provisions of that rule.[6] The Amex also proposes to list long-term options on the Indexes having up to 36 months to expiration. In lieu of such long-term options on the full value of the Indexes, the Amex may instead list long-term options based on one-tenth of the value of each of the Indexes. These long-term options on either the full or reduced-value of the Indexes are referred to as ''LEAPS.'' LEAPS on the Indexes will trade independent of and in addition to regular Index options traded on the Exchange. However, as discussed below, position and exercise limits of LEAPS on the Indexes (both full and reduced-value) and regular options on the Indexes will be aggregated.

B. Composition of the Indexes

The Indexes have been developed by Morgan Stanley to represent a portfolio of large, actively traded, healthcare sector stocks. As of December 1, 1995, the Providers Index was comprised of 15 stocks of companies engaged in the hospital management and medical/nursing services industries, with market capitalizations ranging from $494 million to $23 billion, and six month average daily trading volumes ranging from 95,000 to 995,000 shares. The market capitalization of all of the stocks in the Providers Index on that date was approximately $45.2 billion. The total number of shares outstanding for the stocks in the Providers Index ranged from 19 million shares to 445 million shares.

The Payor's Index, as of December 1, 1995, was comprised of 12 stocks of companies conducting business in the managed health care and health industry services industries, with market capitalizations ranging from $622 million to $10 billion and six month average daily trading volumes ranging from 170,000 to 1,700,000 shares. The market capitalization of all of the stocks in the Payor's Index on that date was approximately $36.3 billion. The total number of shares outstanding for the stocks in the Payor's Index ranged from 18 million shares to 174 million shares.

Finally, as of this same date, the Product Companies Index was comprised of 25 equity issues of companies engaged in the major pharmaceuticals, biotechnology, medical specialities, medical electronics, and medical/dental distributors industries. The market capitalizations of these 25 companies range from $1.6 billion to $56.1 billion and the six month average daily trading volumes range from 124,000 to 2,800,000 shares. The market capitalization of all the stocks in the Product Companies Index on that date was approximately $475 billion. The total number of shares outstanding for the stocks in the Product Companies Index ranged from 29 million shares to 1.5 billion shares.

The Exchange will use an ''equal dollar-weighted'' method to calculate the value of each of the Indexes.[7] The

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[16] *See* Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

[17] 15 U.S.C. 78s(b)(2) (1988).

[18] 17 CFR 200.30–3(a)(12) (1994).

[1] 15 U.S.C. § 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] In Amendment No. 1, the Amex states that for each of the Indexes, if at any time between annual rebalancings, the top five stocks in an Index by weight represent in the aggregate more than 60 percent of the Index's value, the Exchange will rebalance the Index after the close of trading on Expiration Friday in the next month in the March cycle. *See* Letter from Claire P. McGrath, Managing Director and Special Counsel, Derivatives Securities, Amex, to Michael Walinskas, Branch Chief, Office of Market Supervision (''OMS''), Division of Market Regulation (''Division''), Commission, dated January 2, 1996 (''Amendment No. 1'').

[4] *See* Securities Exchange Act Release No. 36715 (January 16, 1996), 61 FR 1796 (January 23, 1996).

[5] In Amendment No. 2 the Exchange clarifies that for each of the Indexes, both eligibility standards and maintenance criteria require that upon annual rebalancing, at least 90 percent of each Index's numerical value and 80 percent of the total number of component securities must meet the then current criteria for standardized options trading set forth in either Exchange Rule 915 for component securities not currently the subject of standardized options trading or Exchange Rule 916 for components currently the subject to standardized options trading. In addition, stocks on each quarterly replacement list will be selected and ranked by Morgan Stanley based on a number of criteria, including conformity to Exchange Rule 915 for securities not currently the subject of standardized options trading and conformity to Rule 916 for securities currently the subject of standardized options trading. *See* Letter from Clifford J. Weber, Managing Director, New Products Development, Amex, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated March 20, 1996 (''Amendment No. 2'').

[6] Amex Rule 902C(d) provides, among other things, that Morgan Stanley does not guarantee the accuracy or completeness of the Indexes or any data included therein, nor does Morgan Stanley make any warranty, either express or implied, as to the results to be obtained by any person or entity from the use of the Indexes or any data included therein.

[7] *See infra* Section II.D entitled ''Calculation of the Indexes'' for a description of this calculation method.

Indexes were each initialized at a level of 200 as of the close of trading on December 16, 1994. As of the close of trading on February 27, 1996, the Providers Index, the Payors Index, and the Product Companies Index were valued at 306.66, 260.46, and 357.07, respectively.[8]

C. Eligibility Standards for the Inclusion of Component Stocks in the Indexes

The Amex represents that the Indexes conform with Exchange Rule 901C, which specifies criteria for the inclusion of stocks in an index on which standardized options will be traded on the Exchange. In addition, for each of the Indexes, Morgan Stanley has included, and will include, only those stocks that initially meet the following standards: (1) a minimum price of $7.50 at the time of announcement of entry into the Index; (2) a minimum market capitalization of $75 million; (3) average monthly trading volume in the component security of at least one million shares during the preceding six months; (4) each component security must be traded on the Amex, NYSE or must be a National Market security traded through the facility of Nasdaq; and (5) upon annual rebalancing, at least 90% of the Index numerical value and at least 80% of the total number of component securities must meet the then current criteria for standardized option trading set forth in Exchange Rule 915 for component securities not currently the subject of standardized options trading and Rule 916 for components which currently are the subject of standardized options trading.[9] Also, because the Indexes are equal-dollar weighted, no component security will represent more than 25% of the weight of any of the Indexes, nor will the five highest weighted component securities in any of the Indexes, in the aggregate, account for more than 60% of the weight of that Index upon annual rebalancing. The criteria set forth above are the same as or exceed many of the criteria established for the expedited listing of options on stock industry indexes pursuant to Exchange Rule 901C Commentary .02.

D. Calculation of the Indexes

The Indexes will be calculated using an ''equal dollar-weighted'' methodology designed to ensure that each of the component stocks are represented in approximately ''equal'' dollar amounts in each Index. In calculating the initial ''equal dollar-weighting'' of component stocks, the Amex, using closing prices on December 16, 1994, calculated the number of shares that would represent an investment of $300,000 in each of the stocks contained in the Indexes (to the nearest whole share). The value of each Index equals the current market value (*i.e.,* based on U.S. primary market prices) of the sum of the assigned number of shares of each of the stocks in the Index portfolio divided by the current Index divisor. Each Index divisor was initially calculated to yield a benchmark value of 200.00 at the close of trading on December 16, 1994. Annually thereafter, following the close of trading on the third Friday of December, each Index portfolio will be adjusted by changing the number of whole shares of each component stock so that each company is again represented in ''equal'' dollar amounts.[10] If necessary, a divisor adjustment is made at the rebalancing to ensure continuity of an Index's value. The newly adjusted portfolio becomes the basis for the Index's value on the first trading day following the annual adjustment.

Subject to the maintenance criteria discussed below, for each Index the number of shares of each component stock in such Index will remain fixed between annual reviews except in the event of certain types of corporate actions, such as the payment of a dividend (other than an ordinary cash dividend), stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or similar event with respect to an Index component stock. In a merger or consolidation of an issuer of a component security, if the security remains in the Index, the number of shares of that security will be adjusted, if necessary, to the nearest whole share, to maintain the component's relative weight in the Index at the level immediately prior to the corporate action. In the event of a stock replacement, the dollar value of the security being replaced will be calculated and that amount invested in the stock of the new component, to the nearest whole share. In all cases, the divisor will be adjusted, if necessary, to ensure Index continuity.

Additionally, for each of the Indexes, if at any time between annual rebalancings, the top five stocks in the Index by weight represent in the aggregate more than 60% of the Index's value, the Exchange will rebalance the Index after the close of trading on expiration Friday in the next month in the March cycle. For example, if in July it is determined that the top five components in the Morgan Stanley Healthcare Product Companies Index account for more than 60% of the Index's weight, then the Index will be rebalanced after the close of trading on expiration Friday in September.[11]

Similar to other stock index values published by the Exchange, the value of each Index will be calculated continuously and disseminated every 15 seconds over the Consolidated Tape Association's Network B and to the Options Price Reporting Authority (''OPRA'').

E. Maintenance of the Indexes

The Indexes will be calculated and maintained by the Amex in consultation with Morgan Stanley which may, from time to time, suggest changes in the industry categories represented in any or all of the Indexes or changes in the number of component stocks in an industry category to properly reflect the changing conditions in the healthcare sector. In addition, the Amex will replace component securities in each Index that fail to meet the following maintenance criteria on quarterly review: (1) a minimum market capitalization of $75 million; (2) average monthly trading volume in the component security of at least 500,000 shares during the preceding six months; (3) at least 90% of the Index's numerical value and at least 80% of the total number of component securities meet the then current criteria for standardized option trading set forth in Exchange Rule 915 for securities not currently the subject of standardized options trading and Rule 916 for securities which are currently the subject of standardized options trading;[12] and (4) a share price of $5.00 or greater for a majority of business days during the preceding quarter for those limited number of component securities that do not meet Rule 915 or 916.[13]

At the beginning of each calendar quarter, Morgan Stanley will provide the Amex with a current list of replacement stocks for each Index from which to draw in the event that a component in an Index must be replaced due to merger, takeover, failure to satisfy the above maintenance

[8] *See* Letter from Clarie P. McGrath, Managing Director and Special Counsel, Derivative Securities, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated February 28, 1996.

[9] *See* Amendment No. 2, *supra* note 5.

[10] In certain circumstances, each Index will be rebalanced prior to the end of a calendar year. *See infra* Section II.E. (Maintenance of the Indexes).

[11] *See* Amendment No. 1, *supra* note 3.

[12] *See* Amendment No. 2, *supra* Note 5.

[13] Telephone conversation between Clifford J. Weber, Managing Director, New Products Development, Amex, and James T. McHale, Attorney, OMS, Division, Commission, on March 19, 1996.

criteria, or other similar event (each a ''Replacement List'').[14] The Amex will publicly distribute the Replacement Lists as soon as practicable following receipt from Morgan Stanley.

Stocks on each Replacement List will be selected and ranked by Morgan Stanley based on a number of criteria, including conformity to the eligibility requirements described above [15] and to Exchange Rule 915 for component securities not currently the subject of standardized options trading and Rule 916 for components which are currently the subject of standardized options trading.[16] Rules 915 and 916, respectively, set forth the criteria for the initial and continued listing of standardized options on equity securities. The replacement stocks will be categorized by Morgan Stanley by industry within the healthcare sector and ranked within their category based on the aforementioned criteria. The replacement stock for a security being removed from an Index will be selected solely by the Amex from the Replacement List based on industry category and liquidity.[17] In the event no replacement stocks are available that meet the eligibility criteria and pass Morgan Stanley's selection process, then the security leaving the Index will be removed without replacement and the divisor adjusted to ensure Index continuity. It is expected that each Index will remain at the current number of components; however, if the number of components in an Index shall increase or decrease by more than one third, the Exchange must obtain additional approval from the Commission pursuant to Section 19(b) of the Act.

In addition, Morgan Stanley will advise the Exchange regarding the handling of unusual corporate actions which may arise from time to time. Routine corporate actions (*e.g.*, stock splits, routine spinoffs, etc.) which require straightforward index divisor adjustments will be handled by the Exchange's staff without consultation with Morgan Stanley. All stock replacements and unusual divisor adjustments caused by the occurrence of extraordinary events such as dissolution, merger, bankruptcy, non-routine spinoffs, or extraordinary dividends will be made by Exchange staff in consultation with Morgan Stanley, although the Amex ultimately will select the actual replacement stock from the Replacement List without Morgan Stanley's assistance. All stock replacements and the handling of non-routine corporate actions will be announced at least ten business days in advance of such effective change, whenever practicable. As with all options currently trading on the Amex, the Exchange will make this information available to the public through the dissemination of an information circular.

F. Expiration and Settlement

The Index value for purposes of settling outstanding Index options and Index LEAPS contracts upon expiration will be calculated based upon the regular way opening sale prices for each of an Index's component stocks in their primary market on the last trading day prior to expiration. In the case of National Market securities traded through Nasdaq, the first reported sale price will be used. Once all of the component stocks have opened for trading, the value of each Index will be determined and that value will be used as the final settlement value for expiring Index options contracts. If any of the component stocks do not open for trading on the last trading day before expiration, then the prior trading day's (*i.e.*, Thursday's) last sale price will be used to calculate each Index. In this regard, before deciding to use Thursday's closing value of a component stock for purposes of determining the settlement value of an Index, the Amex will wait until the end of the trading day on expiration Friday.[18]

G. Contract Specifications

The proposed options on the Indexes will be cash-settled, European-style options.[19] Standard options trading hours for narrow-based index options (9:30 a.m. to 4:10 p.m. New York time) will apply to the contracts. The options on the Index will expire on the Saturday following the third Friday of the expiration month. The last trading day for an expiring option series will normally be the second to the last business day before expiration (normally a Thursday). The Exchange intends to list option series with expirations in the three near-term calendar months and the two additional calendar months in three month intervals in the March cycle. The Exchange also intends to list longer term option series having up to 36 months to expiration. The Exchange proposes to list near-the-money (i.e. strike prices within ten points above or below the current index value) option series on any of the Indexes at 2½ point strike price intervals when the value of that Index is below 200 points.

H. Listing of Long-Term Options on the Full Value or the Reduced Value of the Indexes

The proposal provides that the Exchange may list longer term index options series having up to 36 months to expiration on the full value of the Indexes. Alternatively, the Exchange may list long-term reduced-value put and call options based on ⅒th of the full value of the Indexes. In either event, the interval between expiration months for either a full value or reduced value long-term option will not be less than six months. The reduced-value Index LEAPS will also have a European-style exercise and will be subject to the same rules that govern the trading of all the Exchange's index options, including sales practice rules, margin requirements and floor trading procedures.

I. Position and Exercise Limits, Margin Requirements, and Trading Halts

Because the Indexes are Stock Index Options under Amex Rule 901C(a) and Stock Index Industry Groups under Rule 900C(b)(1), the proposal provides that Exchange rules that are applicable to the trading of narrow-based index options will apply to the trading of options on the Indexes. Specifically, Exchange rules governing margin requirements,[20] position and exercise limits,[21] and trading halt procedures [22] that are

[14] *See* Letter from Carol Shahmoon, Counsel, Morgan Stanley, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated March 20, 1996 (''Morgan Stanley Letter'').

[15] *See supra* Section II.C entitled ''Eligibility Standards for the Inclusion of Component Stocks in the Indexes.''

[16] *See* Amendment No. 2, *supra* Note 5.

[17] The Amex will ensure that at the time of selection it will only select securities that continue to meet the eligibility requirements discussed above.

[18] For purposes of the daily dissemination of the Indexes value, if a stock included in an Index has not opened for trading, the Amex will use the closing value of that stock in its primary market on the prior trading day when calculating the value of the Index, until the stock opens for trading.

[19] A European-style option can be exercised only during a specified period before the option expires.

[20] Pursuant to Amex Rule 462(d)(2)(D)(iv), the margin requirements for each of the proposed Index options will be: (1) for each short options position, 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 Index value; and (2) for long options positions, 100% of the options premium paid.

[21] Pursuant to Amex Rules 904C and 905C, respectively, the position and exercise limits for each of the proposed Index options will be 12,000 contracts, unless the Exchange determines, pursuant to Rules 904C and 905C, that a lower limit is warranted.

[22] Pursuant to Amex Rule 918C, the trading of options on each of the Indexes will be halted or suspended whenever trading in underlying

applicable to the trading of narrow-based index options will apply to options traded on the Indexes. Position limits on long-term reduced-value Index options will be equivalent to the position limits for regular (full value) Index options and would be aggregated with such options. For aggregation purposes, ten reduced value contracts will equal one full value contract (for example, if the position limit for the full value options is 12,000 contracts on the same side of the market, then the position limit for the reduced value options will be 120,000 contracts on the same aside of the market).

J. 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 options on the Indexes. These procedures include complete access to trading activity in the underlying securities. Further, the Intermarket Surveillance Group (''ISG'') Agreement, dated July 14, 1983, as amended on January 29, 1990, will be applicable to the trading of options on the Indexes.[23]

Morgan Stanley has also adopted special procedures to prevent the potential misuse of material, non-public information by the research, sales, and trading divisions of the firm in connection with the maintenance of the Indexes.[24] As discussed above, the Amex will publicly disseminate each Replacement List by issuing information circulars so that investors will know in advance which securities will be considered as replacements for the Index.[25]

In additional, Morgan Stanley will have a limited role in the stock replacement selection and substitution process. First, when a stock in an Index no longer meets the published criteria as determined following a quarterly review of the components by the Exchange, the Amex will determine, without consultation with Morgan Stanley, which security from the applicable Replacement List will be selected for addition to the Index. Second, The Amex will also make adjustments as a result of stock splits, routine spin-offs, and otherwise, without consultation with Morgan Stanley. Finally, even in those situations where the Amex consults with Morgan Stanley, upon the occurrence of certain events, the actual replacement sock will be selected solely by Amex from the stocks on the replacement list.

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 a national securities exchange, and, in particular, the requirements of Section 6(b)(5).[26] Specifically, the Commission finds that the trading of options on the Indexes, 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 an additional means to hedge exposure to market risk associated with stocks in the various healthcare subsectors.[27]

The trading of options on the Indexes and reduced-value Indexes, however, raises several issues relating to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the Amex adequately has assessed these issues.

A. Index Design and Structure

The Commission believes it is appropriate for the Exchange to designate each of the Indexes as narrow-based for purposes of index options training. The indexes are each comprised of a limited number of stocks intended to track discrete subsectors of the healthcare sector of the stock market. Accordingly, the Commission believes it is appropriate for the Amex to apply its rules governing narrow-based index options to trading in the proposed Index options.[28]

The Commission also believes that the liquid markets, large capitalizations, and relative weighings of the Indexes' component stocks significantly minimize the potential for manipulation of the Index. First, the stocks that comprise each index are actively traded. Average month trading volume in the component stocks of the Indexes for the period between June 1, 1995 and December 1, 1995 ranged from 95,000 to 995,000 shares for the Providers Index, 170,000 to 1,700,000 shares for the Payors Index, and 124,000 to 2,800,000 shares for the Product Companies Index. Second, the market capitalizations of the stocks in the Indexes are very large, ranging from $494 million to $23 billion in the Providers Index, $622 million to $10 billion in the Payors Index, and $1.6 billion to $56 billion in the Product Companies Index. Third, because the indexes are equal dollar-weighted, no one particular stock or group of stocks dominates the index. Specifically, as of December 1, 1995, no one stock accounted for more than 12.13% of the total value of the Providers Index, 12.47% of the total value of the Payors Index, and 6.38% of the total value of the Product Companies Index. Fourth, the Indexes will be maintained so that in addition to the other maintenance criteria discussed above, at each quarterly review and rebalancing (annual or otherwise), at least 90% of the Indexes numerical value and at least 80% of the total number of component securities will be composed of securities eligible for standardized options trading. Fifth, Morgan Stanley and the Amex will be required to ensure that each component of each Index is subject to last sale reporting requirements in the U.S. pursuant to Rule 11aA3–1 of the Act. This will further reduce the potential for manipulation of the value of the Indexes. Finally, the Commission believes that the existing mechanisms to monitor trading activity in the component stocks of the Indexes, or options on those stocks or the Indexes will help deter as well as detect any illegal activity.

securities whose weighted value represents more than 20% of an Index's value are halted or suspended.

[23] 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 Chicago Board Options Exchange, Inc.; the Chicago Stock Exchange, Inc.; the National Association of Securities Dealers, Inc.; 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.

[24] *See* Morgan Stanley Letter, *supra* note 14.

[25] *Id.*

[26] 15 U.S.C. § 78f(b)(5).

[27] 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 derivate instrument that served no hedging or other economic function, because any benefits that might be derived by market participants likely would be out weighed 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 options on the Index will provide investors with a hedging vehicle that should reflect the overall movement of the stocks representing companies in the healthcare sector in the U.S. stock markets.

[28] *See supra* Section II.I (Position and Exercise Limits, Margin Requirements, and Trading Halts).

In addition, even though the Indexes are only scheduled to be rebalanced annually, the Commission believes that the Amex and Morgan Stanley have developed several composition and maintenance criteria for the Indexes that will minimize the possibility that the Indexes could be manipulated through trading in less actively traded securities or securities with smaller prices or floats. First, if at any time during the year the top five components in an Index, by weight, account for more than sixty percent of the weight of the Index, the Exchange will rebalance the Index following the close of trading on Expiration Friday in the next month in the March cycle. These rebalancing requirements will serve to ensure that any ''overweight'' stock [29] will be brought back into line with the other stocks, thus ensuring that less capitalized stocks do not become excessively weighted in the Index.

Second, after each quarterly review and each rebalancing (annual or otherwise), at least 90% of an Index's numerical value and at least 80% of the total number of component securities will be comprised of stocks that are eligible for standardized options trading. The Commission believes that this requirement will ensure that the Indexes will be almost entirely made up of stocks with large public floats that are actively traded, thus reducing the likelihood that the Indexes could be easily manipulated by abusive trading in the smaller stocks contained in the Indexes.

Third, at each quarterly review of the Indexes, a component may only remain in an Index if it satisfies the remaining maintenance requirements which include market capitalization and minimum trading volume requirements.[30] These requirements are similar to the continued listing requirements for options on individual equity securities and should ensure the Indexes are comprised of active and liquid securities.[31]

Fourth, because the Indexes are narrow-based, the applicable position and exercise limits (currently 12,000) and margin requirements will further reduce the susceptibility of the Indexes to manipulation. Lastly, Morgan Stanley will only add stocks to a Replacement List that are representative of the healthcare sector and, as discussed above,[32] satisfy the inclusion criteria.

The Commission notes that certain concerns are raised when a broker-dealer, such as Morgan Stanley, is involved in the development and maintenance of a stock index that underlies an exchange-traded derivative product. For several reasons, however, the Commission believes that the Amex has adequately addressed this concern with respect to options on the Indexes.

First, the values of the Indexes are to be calculated and disseminated by the Amex so that unless a party independently calculates the Indexes' values, neither Morgan Stanley nor any other party will be in receipt of the values prior to the public dissemination of the Indexes' values. Second, routine corporate actions (*e.g.*, stock splits, routine spinoffs, etc.) will be handled by the Amex without consultation with Morgan Stanley. Third, although stock replacements and unusual divisor adjustments caused by the occurrence of extraordinary events, such as dissolution, merger, bankruptcy, non-routine spinoffs, or extraordinary dividends, will be made by Exchange staff in consultation with Morgan Stanley, Amex alone ultimately will select the actual replacement stock from the Replacement List without Morgan Stanley's assistance. Such replacement will be announced publicly at least 10 business days in advance of the effective change by the Amex through the dissemination of an information circular, whenever practicable. Fourth, the Commission believes that the procedures Morgan Stanley has established to detect and prevent material non-public information concerning the Indexes from being improperly used by the person or persons responsible for compiling the Replacement Lists, as well as other persons within Morgan Stanley, as discussed above,[33] adequately serve to minimize the susceptibility to manipulation of the Indexes, the securities in the Indexes, and securities added to and deleted from any Replacement List. In summary, the Commission believes that the procedures outlined above help to ensure that Morgan Stanley will not have any informational advantages concerning modifications to the composition of the Indexes due to its limited role in consulting with Amex on the maintenance of the Indexes under certain circumstances.

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 options on the Indexes (including full-value and reduced value 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 LEAPS and regular options on the Indexes will be subject to the same regulatory regime as the other standardized options currently traded on the Amex, the Commission believes that adequate safeguards are in place to ensure the protection of investors in options on the Indexes. Finally, the Amex has stated that it will distribute information circulars to members following rebalancings and prior to component changes to notify members of changes in the composition of the Indexes. Additionally, the Amex will publicly disseminate each Replacement List by means of information circulars. The Commission believes this should help to protect investors and avoid investor confusion.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation.[34] In this regard, the Amex, NYSE, and National Association of Securities Dealers, Inc. are all members of the ISG, which provides for the exchange of all necessary surveillance information.[35]

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[29] A stock would be ''overweight'' if its weight in the Index were greater than the average weight of all of the stocks in the Index. This would occur, for example, if the price of a component stock significantly increased relative to the other stocks in the Index during a particular quarter and prior to the rebalancing.

[30] *See supra* Section II.E (Maintenance of the Indexes).

[31] *See* Amex Rule 916.

[32] *See supra* Section II.C (Eligibility Standards for the Inclusion of Component Stocks in the Indexes).

[33] *See* Morgan Stanley Letter, *supra* note 14.

[34] *See* Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992).

[35] *See supra* note 23.

D. Market Impact

The Commission believes that the listing and trading of options on the Indexes, including full-value and reduced-value Index LEAPS, on the Amex will not adversely impact the underlying securities markets.[36] First, as described above, due to the ''equal dollar-weighting'' methodology, no one stock or group of stocks dominates the Indexes. Second, because at each quarterly review and each rebalancing of the Indexes, at least 90% of an Index's numerical value and at least 80% of the total number of component securities must be accounted for by stocks that are eligible for standardized options trading, the component stocks generally will be actively-traded, highly-capitalized stocks. Third, the currently applicable 12,000 contract position and exercise limits will serve to minimize potential manipulation and market impact concerns. Fourth, the risk to investors of contra-party non-performance will be minimized because the options on the Indexes will be issued and guaranteed by the Options Clearing Corporation just like any other standardized option traded in the United States.

Lastly, the Commission believes that settling expiring options on the Indexes (including full-value and reduced-value Index LEAPS) based on the opening prices of component securities is reasonable and 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 stocks underlying options on the Index.[37]

The Commission finds good cause for approving Amendment No. 2 to the proposal prior to the thirtieth day after the date of publication of the notice of filing thereof in the Federal Register. Specifically, Amendment No. 2 merely clarifies that for each of the Indexes, both eligibility standards and maintenance criteria require that upon annual rebalancing, at least 90% of each Index's numerical value and 80% of the total number of component securities must meet the then current criteria for standardized options trading set forth in either Rule 915 for component securities not currently the subject of standardized options trading or Rule 916 components which are currently the subject of standardized options trading. Moreover, Amendment No. 2 provides that Morgan Stanley will select and rank any stocks to be included in each Replacement List based on a number of criteria, including conformity to the same eligibility standards and maintenance criteria set forth in Rules 915 and 916. The Commission believes that clarifying the applicable eligibility standards and maintenance criteria for the Indexes' component securities is consistent with maintaining a fair and orderly market and reduces the likelihood of investor confusion.

Based on the above, the Commission finds good cause for approving Amendment No. 2 to the proposed rule change on an accelerated basis and believes that the proposal, as amended, is consistent with Sections 6(b)(5) and 19(b)(2) of the Act.

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 NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street NW., Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to the File No. SR–Amex–95–53 and should be submitted by April 19, 1996.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[38] that the proposed rule change (SR–Amex–95–53), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[39]

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[Release No. 34–37011; File Nos. SR–CBOE–95–58; SR–Amex–95–47; Phlx–95–90; SR–PSE–96–05; SR–NYSE–96–03]

Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Related Amendments by the Chicago Board Options Exchange, Inc., the American Stock Exchange, Inc. and the Philadelphia Stock Exchange, Inc., and Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Changes by the Pacific Stock Exchange, Inc., and the New York Stock Exchange, Inc., Relating to Listing Standards for Options on Securities Issued in a Reorganization Transaction Pursuant to a Public Offering or a Rights Distribution

March 22, 1996.

I. Introduction

On October 19, November 29, December 19, 1995, February 16, and March 1, 1996 the Chicago Board Options Exchange, Inc. (''CBOE''), the American Stock Exchange, Inc. (''Amex''), the Philadelphia Stock Exchange, Inc. (''Phlx''), the Pacific Stock Exchange, Inc. (''PSE'') and the New York Stock Exchange, Inc. (''NYSE'') (collectively the ''Exchanges''), respectively, submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] proposed rule changes to adopt listing standards for options on securities issued in a reorganization transaction pursuant to a public offering or a rights distribution.

Notices of the CBOE, Amex, and Phlx proposals were published for comment in the Federal Register on December 6, 1995, December 11, 1995, and December 29, 1995, respectively.[3] No comments were received on the proposals. The CBOE submitted to the Commission Amendment Nos. 1 and 2 to its proposal

[36] In addition, the Amex and the OPRA have represented that the Amex and the OPRA have the necessary systems capacity to support those new series of index options that would result from the introduction of options on the Indexes. *See* Letter from Charles Faurot, Managing Director, Market Data Services, Amex, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated January 22, 1996; letter from Edward Cook, Jr., Managing Director, Information Technology, Amex, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated February 8, 1996; and letter from Joe Corrigan, Executive Director, OPRA, to Michael Walinskas, Branch Chief, OMS, Division, Commission, dated January 22, 1996.

[37] Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

[38] 15 U.S.C. § 78s(b)(2).

[39] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release Nos. 36528 (November 29, 1995), 60 FR 62523 (File No. SR–CBOE–95–58); 36550 (December 4, 1995), 60 FR 63550 (File No. SR–Amex–95–47); and 36625 (December 21, 1995), 60 FR 67378 (File No. SR–Phlx–95–90).