

thereunder,² a proposed rule change to amend its rule relating to the suspension of members and associated persons who fail to pay debts owed to the Exchange.

The proposed rule change was published for comment in Securities Exchange Act Release No. 39026 (Sept. 8, 1997), 62 FR 48123 (Sept. 12, 1997). No comments were received on the proposal. This order approves the proposal.

Rule 2.23 presently requires that members or associated persons who fail to pay any debts owed to the Exchange within 30 days after they become due may be suspended from membership or association with a member by the Chairman of the Executive Committee until payment is made.

The Exchange proposes to amend this rule to clarify the application of Rule 2.23 to former members and persons associated with members by providing expressly that such persons who fail to pay debts owed to the Exchange may be barred from becoming a member and associated person by the Chairman of the Executive Committee until payment is made.

The Exchange also proposes to add new Interpretation .02 to provide that the Exchange will report any suspension or bar imposed pursuant to Rule 2.23 to the Central Registration Depository ("CRD"). This new paragraph is similar to CBOE Rule 17.14 which provides for the reporting by the Exchange to the CRD of information concerning pending formal Exchange disciplinary proceedings. The Exchange also proposes to delete references to a regular membership and special membership in the current Rule 2.23, as CBOE no longer has any special memberships, and to add language clarifying that if a member fails to pay an Exchange debt within 6 months, the Chairman of the Executive Committee may dispose of any memberships owned by that member in accordance with Rule 3.41(b).

Finally, the proposed rule change also includes several nonsubstantive language changes.

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, and, in particular, with the requirements of Section 6(b).³ Specifically, the Commission believes the proposal is consistent with the Section 6(b)(5)⁴ requirements that the rules of an

exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest.⁵ In this regard, the Commission believes that the proposed rule change will enhance the public's access to information concerning suspensions and bars imposed by the CBOE upon its members and associated persons.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁶ that the proposed rule change (SR-CBOE-97-33) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁷

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39268; File No. SR-CSE-97-10]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Cincinnati Stock Exchange, Inc. Relating to Listing and Trading Standards for Portfolio Depository Receipts

October 22, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 14, 1997,³ the Cincinnati Stock Exchange, Inc. ("CSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. The

⁵ In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁶ 15 U.S.C. 78s(b)(2).

⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange filed Amendment No. 1 to the proposed rule change on October 20, 1997, the substance of which is incorporated into this release. See letter from Adam Gurwitz, Vice President Legal, CSE, the Heather Seidel, Attorney, Market Regulation, Commission, dated October 17, 1997 ("Amendment No. 1").

Commission is also granting accelerated approval of the proposed rule change.

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

The CSE proposes to adopt new Exchange rule 11.9(v), to provide listing standards for, and trading in Portfolio Depository Receipts ("PDRs"). The text of the proposed rule change is available at the Office of the Secretary, CSE 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 self-regulatory organization 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 III below. The self-regulatory organization 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

1. Purpose

a. Listing Requirements for Portfolio Depository Receipts. The Exchange proposes to adopt new Rule 11.9(v) to accommodate the trading of PDRs, i.e., securities that are interests in a unit investment trust ("Trust") holding a portfolio of securities linked to an index. Each Trust will provide investors with an instrument that (1) closely tracks the underlying portfolio of securities, (2) trades like a share of common stock, and (3) pays holders of the instrument periodic dividends proportionate to those paid with respect to the underlying portfolio of securities, less certain expenses (as described in the Trust prospectus).

Under the proposal, the Exchange may list and trade, or trade pursuant to unlisted trading privileges, PDRs based on one or more stock indices or securities portfolios. PDRs based on each particular stock index or portfolio will be designated as a separate series and identified by a unique symbol. The stocks that are included in an index or portfolio on which PDRs are based will be selected by the Exchange, or by another person having a proprietary interest in and authorized use of such index or portfolio, and may be revised as may be deemed necessary or

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78f(b).

⁴ 15 U.S.C. 78f(b)(5).

appropriate to maintain the quality and character of the index or portfolio.

In connection with an initial listing, the Exchange proposes that, for each Trust of PDRs, the Exchange will establish a minimum number of PDRs required to be outstanding at the time of commencement of Exchange trading, and such minimum number will be filed with the Commission in connection with any required submission under Rule 19b-4 for each Trust. If the Exchange trades a particular PDR pursuant to unlisted trading privileges, the Exchange will follow the listing exchange's determination of the appropriate minimum number.

Because the Trust operates on an open-end type basis, and because the number of PDR holders is subject to substantial fluctuations depending on market conditions, the Exchange believes it would be inappropriate and burdensome on PDR holders to consider suspending trading in or delisting a series of PDRs, with the consequent termination of the Trust, unless the number of holders remains severely depressed during an extended time period. Therefore, twelve months after the formation of a Trust and commencement of Exchange trading, the Exchange will consider suspension of trading in, or removal from listing of, a Trust when, in its opinion, further dealing in such securities appears unwarranted under the following circumstances:

- (a) If the Trust on which the PDRs are based has more than 60 days remaining until termination and there have been fewer than 50 record and/or beneficial holders of the PDRs for 30 or more consecutive trading days; or
- (b) If the index on which the Trust is based is no longer calculated; or
- (c) If such other event occurs or condition exists which, in the opinion of the Exchange, makes further dealings in such securities on the Exchange inadvisable.

A Trust will terminate upon removal from Exchange listing and its PDRs will be redeemed in accordance with provisions of the Trust prospectus. A Trust may also terminate under such other conditions as may be set forth in the Trust prospectus. For example, the sponsor of the Trust (the "Sponsor"), following notice to PDR holders, will have discretion to direct that the Trust be terminated if the value of securities in such Trust falls below a specified amount.

B. Trading of PDRs. Dealing in PDRs on the Exchange will be conducted pursuant to the Exchange's general agency-auction trading rules. The Exchange's general dealing and

settlement rules would apply, including its rules on clearance and settlement of securities transactions and its equity margin rules. Other generally applicable Exchange equity rules and procedures would also apply including, among others, rules governing the priority, parity and precedence of orders and the responsibilities of specialists.⁴

The CSE has represented that the Exchange understands that SPDRs and MidCap SPDRs will both become ITS System securities on October 24, 1997. The Exchange intends to trade both SPDRs and MidCap SPDRs when they become ITS System securities, but does not intend to trade them before that time.

With respect to trading halts, the trading of PDRs would be halted, along with trading of all other listed or traded stocks, in the event the "circuit breaker" thresholds are reached.⁵ In addition, for PDRs tied to an index, while the triggering of futures price limits for the S&P 500 Composite Price Index ("S&P 500 Index"), S&P Composite Price Stock Index ("S&P 100 Index") or Major Market Index ("MMI") futures contracts will not, in themselves, result in a halt in PDR trading or a delayed opening, such an event could be considered by the Exchange, along with other factors, such as a halt in trading in S&P 100 Index Options ("OEX"), S&P 500 Index Options ("SPX"), or Major Market Index Options ("XMI"), in deciding whether to halt trading in PDRs.

The Exchange will issue a circular to its Members and Member Organizations informing them of Exchange policies regarding trading halts in such securities. For a PDR based on an index, these factors would include whether trading has been halted or suspended in the primary market(s) for any combination of underlying stocks accounting for 20% or more of the applicable current index group value; or whether other unusual conditions or circumstances detrimental to the

maintenance of a fair and orderly market are present.

c. Disclosure. Proposed Rule 11.9(v) requires that Members and Member Organizations provide to all purchasers of each series of PDRs a written description of the terms and characteristics of such securities, in a form approved by the Exchange, not later than the time a confirmation of the first transaction in such series of PDRs is delivered to such purchaser. In this regard a Member or Member Organization carrying an omnibus account for a non-member broker-dealer will be required to inform such non-member that execution of an order to purchase PDRs for such omnibus account will be deemed to constitute an agreement by the non-member to make such written description available to its customers on the same terms as are directly applicable to Members and Member Organizations. The written description must be included with any sales material on that series of PDRs that a Member provides to customers or the public. Moreover, other written materials provided by a Member or Member Organization to customers or the public making specific reference to a series of PDRs as an investment vehicle must include a statement in substantially the following form: "A circular describing the terms and characteristics of [the series of PDRs] is available from your broker. It is recommended that you obtain and review such circular before purchasing [the series of PDRs]. In addition, upon request you may obtain from your broker a prospectus for [the series of PDRs]." Additionally, as noted above, the Exchange requires that Members and Member Organizations provide customers with a copy of the prospectus for a series of PDRs upon request.

Two existing PDRs, Standard & Poor's Depository Receipts ("SPDRs") and Standard & Poor's MidCap 400 Depository Receipts ("MidCap SPDRs"), are traded on the American Stock Exchange ("Amex").⁶ The Exchange is not asking for permission to list SPDRs or MidCap SPDRs pursuant to unlisted trading privileges once the generic listing standards set forth herein are approved.

Pursuant to SEC Rule 12f-5, in order to trade a particular class or type of security pursuant to unlisted trading privileges, the Exchange must have rules providing for transactions in such class or type of security. The Amex has enacted listing standards for PDRs, and the Exchange's proposed rule change is

⁴ CSE Rule 3.7, Recommendations to Customers, will also apply to transactions in PDRs, including SPDRs and MidCap SPDRs. That rule provides that when recommending to a customer the purchase, sale or exchange of any security, a member or member organization shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts disclosed by such customer, after reasonable inquiry by the member or member organization, as to the customer's other securities holdings and as to the customer's financial situation and needs. Telephone conversation between Adam Gurwitz, Vice-President Legal, CSE, and Heather Seidel, Attorney, Market Regulation, Commission, on October 17, 1997.

⁵ See Securities Exchange Act Release No. 38221 (January 31, 1997), 62 FR 5871 (February 7, 1997) and note 7 therein.

⁶ SPDRs and MidCap SPDRs are defined and discussed more fully below.

designed to create similar standards for PDR listing and/or trading on the CSE. As stated above, the Exchange proposes to trade SPDRs and MidCap SPDRs pursuant to unlisted trading privileges upon approval of this rule filing.

If at a later time the Exchange and the issuer of the product desires to list SPDRs and MidCap SPDRs or any other PDRs on the Exchange, the Exchange will request SEC approval for that listing in a separate proposed rule change filed pursuant to Section 19(b) of the Act. Additionally, in the event a new PDR is listed on another exchange using listing standards that are different than current Exchange listing standards or the Exchange listing standards proposed in this filing, the Exchange will file a proposed rule change pursuant to Section 19(b) of the Act to adopt the listing standards before it trades that PDR pursuant to unlisted trading privileges.

With respect to disclosure, because SPDRs and MidCap SPDRs will be traded pursuant to unlisted trading privileges and will not be listed on the Exchange at this time, the Exchange does not intend to create its own product description to satisfy the requirements of proposed Rule 11.9(v), which requires members to provide to purchasers, a written description of the terms and characteristics of SPDRs and MidCap SPDRs in a form approved by the Exchange. Instead, the Exchange will deem a member or member organization to be in compliance with this requirement if the member delivers either (i) the current product description produced by the Amex from time to time, or (ii) the current prospectus for the SPDR or MidCap SPDR, as the case may be.⁷ It will be the member's responsibility to obtain these materials directly from Amex for forwarding to purchasers in the time frames prescribed by Exchange and Commission rules. The Exchange will notify members and member organizations of this requirement in a notice to members.

The remainder of this section of the proposed rule change provides background information on SPDRs and MidCap SPDRs. The information, requested by CSE to have been copied from SR-AMEX-94-52 and SR-AMEX-92-18, describes the structure and

⁷ CSE plans to notify its members in a regulatory circular that members must comply with Rule 3.7, Recommendations to Customers, prior to recommending the purchase of SPDRs or MidCap SPDRs to customers. The circular will also state that members must deliver a SPDR or MidCap SPDR product description to all purchasers of the products and that they must provide the prospectus upon the request.

mechanics of SPDRs and MidCap SPDRs.

d. SPDRs and MidCap SPDRs Generally. On December 11, 1992, the Commission approved Amex Rules 1000 et seq.⁸ to accommodate trading on the Amex of PDRs generally. The Sponsor of each series of PDRs traded on the Amex is PDR Services Corporation, a wholly-owned subsidiary of the Amex. The PDRs are issued by a Trust in a specified minimum aggregate quantity ("Creation Unit") in return for a deposit consisting of specified numbers of shares of stock plus a cash amount.

The first Trust to be formed in connection with the issuance of PDRs was based on the S&P 500 Index, known as Standard & Poor's Depository Receipts ("SPDRs"). SPDRs have been trading on the Amex since January 29, 1993. The second Trust to be formed in connection with the issuance of PDRs was based on the S&P MidCap 400 Index,⁹ known as Standard & Poor's MidCap 400 Depository Receipts ("MidCap SPDRs").¹⁰ The sponsor of the two Trusts has entered into trust agreements with a trustee in accordance with Section 26 of the Investment Company Act of 1940. PDR Distributors, Inc. ("Distributor") acts as underwriter of both SPDRs and MidCap SPDRs on an agency basis. The Distributor is a registered broker-dealer, a member of the National Association of Securities Dealers, Inc., and a wholly-owned subsidiary of Signature Financial Group, Inc.¹¹

E. SPDRs. The Trustee of the SPDR Trust will have the right to vote any of the voting stocks held by the Trust, and will vote such stocks of each issuer in the same proportion as all other voting shares of that issuer voted.¹² Therefore, SPDR holders will not be able to directly vote the shares of the issuers underlying the SPDRs.

⁸ See Securities Exchange Act Release No. 31591 (December 11, 1992), 57 FR 60253 (December 18, 1992).

⁹ The S&P MidCap 400 Index is a capitalization-weighted index of 400 actively traded securities that includes issues selected from a population of 1,700 securities, each with a year-end market-value capitalization of between \$200 million and \$5 billion. The issues included in the Index cover a broad range of major industry groups, including industrials, transportation, utilities, and financials.

¹⁰ See Securities Exchange Act Release No. 35534 (March 24, 1995), 60 FR 16686 (March 31, 1995).

¹¹ The Commission has recently approved a rule change proposal covering the trading and listing of PDRs on CHX, including SPDRs and MidCap SPDRs. See Securities Exchange Act Release No. 39076 (September 15, 1997), 62 FR 49270 (September 19, 1997) ("CHX Approval Order").

¹² The Trustee will abstain from voting if the stocks held by the Trust cannot be voted in the same proportion as all other shares of the securities are voted.

The Trust will issue SPDRs in exchange for "Portfolio Deposits" of all of the S&P 500 Index securities weighted according to their representation in the Index.¹³ An Investor making a Portfolio Deposit into the Trust will receive a "Creation Unit" composed of 50,000 SPDRs.¹⁴ The price of SPDRs will be based on a current bid/offer market. The Amex has designated 1/64's as the minimum increment for trading in SPDRs. The Exchange has proposed this same minimum variation for trading of SPDRs on the CSE. SPDRs will not be redeemable individually, but may be redeemed in Creation Unit size (i.e., 50,000 SPDRs). Specifically, a Creation Unit may be redeemed for an in-kind distribution of securities identical to a Portfolio Deposit.¹⁵ PDR Distribution Services, Inc. a registered broker-dealer, will act as underwriter of SPDRs on an agency basis.

F. MidCap SPDRs. All orders to create MidCap SPDRs in Creation Unit size aggregations (which has been set at 25,000) must be placed with the Distributor, and it will be the responsibility of the Distributor to transmit such orders to the Trustee.

To be eligible to place orders to create MidCap SPDRs as described below, an entity or person either must be a participant in the Continuous Net Settlement ("CNS") system of the National Securities Clearing Corporation ("NSCC") or a Depository Trust Company ("DTC") participant. Upon acceptance of an order to create a MidCap SPDRs, the Distributor will instruct the Trustee to initiate the book-entry movement of the appropriate number of MidCap SPDRs to the account of the entity placing the order. MidCap SPDRs will be maintained in book-entry form at DTC.

Payment with respect to creation orders placed through the Distributor

¹³ A Portfolio deposit also will include a cash payment equal to a pro rata portion of the dividends accrued on the Trust's portfolio securities since the last dividend payment by the Trust plus or minus an amount designed to compensate for any difference between the net asset value of the Portfolio Deposit and the S&P 500 Index caused by, among other things, the fact that a Portfolio Deposit cannot contain fractional shares.

¹⁴ The Trust is structured so that the net asset value of an individual SPDR should equal one-tenth of the value of the S&P 500 Index.

¹⁵ An investor redeeming a Creation Unit will receive Index securities and cash identical to the Portfolio Deposit required of an investor wishing to purchase a Creation Unit on that particular day. Since the Trust will redeem in kind rather than for cash, the Trustee will not be forced to maintain cash reserves for redemptions. This should allow the Trust's resources to be committed as fully as possible to tracking the S&P 500 Index, enabling the Trust to track the Index more closely than other basket products that must allocate a portion of their assets for cash redemptions.

will be made by (1) the "in-kind" deposit with the Trustee of a specified portfolio of securities that is formulated to mirror, to the extent practicable, the component securities of the underlying index or portfolio, and (2) a cash payment sufficient to enable the Trustee to make a distribution to the holders of beneficial interests in Trust on the next dividend payment date as if all the securities had been held for the entire accumulation period for the distribution ("Dividend Equivalent Payment"), subject to certain specified adjustments. The securities and cash accepted by the Trustee are referred to, in the aggregate, as a "Portfolio Deposit."

G. Issuance of MidCap SPDRs. Upon receipt of a Portfolio Deposit in payment for a creation order placed through the Distributor as described above, the Trustee will issue a specified number of MidCap SPDRs, which aggregate number is referred to as a "Creation Unit." A Creation Unit is made up of 25,000 MidCap SPDRs.¹⁶ Individual MidCap SPDRs can then be traded in the secondary market like other equity securities. Portfolio Deposits are expected to be made primarily by institutional investors, arbitrageurs, and Exchange specialists.

The Trustee or Sponsor will make available (1) on a daily basis, a list of the names and required number of shares for each of the securities in the current Portfolio Deposit; (2) on a minute-by-minute basis throughout the day, a number representing the value (on a per MidCap SPDR basis) of the securities portion of a Portfolio Deposit in effect on such day; and (3) on a daily basis, the accumulated dividends, less expenses, per outstanding MidCap SPDR.

The Amex has set the minimum fractional trading variation for MidCap SPDRs at 1/64 of \$1.00. The Exchange is proposing this same minimum variation for MidCap SPDRs.

H. Redemption of MidCap SPDRs. MidCap SPDRs in Creation Unit size aggregations will be redeemable in kind by tendering them to the Trustee. While holders may sell MidCap SPDRs in the secondary market at any time, they must accumulate at least 25,000 (or multiples thereof) to redeem them through the Trust. MidCap SPDRs will remain outstanding until redeemed or until the termination of the Trust. Creation Units will be redeemable on any business day in exchange for a portfolio of the securities held by the Trust identical in weighting and composition to the

securities portion of a Portfolio Deposit in effect on the date a request is made for redemption, together with a "Cash Component" (as defined in the Trust prospectus), including accumulated dividends, less expenses, through the date of redemption. The number of shares of each of the securities transferred to the redeeming holder will be the number of shares of each of the component stocks in a Portfolio Deposit on the day a redemption notice is received by the Trustee, multiplied by the number of Creation Units being redeemed. Nominal service fees may be charged in connection with the creation and redemption of Creation Units. The Trustee will cancel all tendered Creation Units upon redemption.

I. Distributions for MidCap SPDRs. The MidCap SPDR Trust will pay dividends quarterly. The regular quarterly ex-dividend date for MidCap SPDRs will be the third Friday in March, June, September, and December, unless that day is a New York Stock Exchange holiday, in which case the ex-dividend date will be the preceding Thursday. Holders of MidCap SPDRs on the business day preceding the ex-dividend date will be entitled to receive an amount representing dividends accumulated through the quarterly dividend period preceding such ex-dividend date net of fees and expenses for such period. The payment of dividends will be made on the last Exchange business day in the calendar month following the ex-dividend date ("Dividend Payment Date"). On the Dividend Payment Date, dividends payable for those securities with ex-dividend dates falling within the period from the ex-dividend date most recently preceding the current ex-dividend date will be distributed. The Trustee will compute on a daily basis the dividends accumulated within each quarterly dividend period. Dividend payments will be made through DTC and its participants to all such holders with funds received from the Trustee.

The MidCap SPDR Trust intends to make the DTC DRS available for use by MidCap SPDR holders through DTC participant brokers for reinvestment of their cash proceeds. The DTC DRS is also available to holders of SPDRs. Because some brokers may choose not to offer the DTC DRS, an interested investor would have to consult his or her broker to ascertain the availability of dividend reinvestment through that broker. The Trustee will use cash proceeds of MidCap SPDR holders participating in the reinvestment to obtain the Index securities necessary to

create the requisite number of SPDRs.¹⁷ Any cash remaining will be distributed pro rata to participants in the dividend reinvestment.

The Exchange requests accelerated approval of the proposed rule change pursuant to Section 19(b)(2) of the Act. The Exchange believes that accelerated approval is appropriate because the listing standards proposed in the proposed rule change closely mirror both the listing standards of the primary market for SPDRs and Mid-Cap SPDRs, Amex, and the standards proposed by two other regional exchanges that have announced their intention to trade PDRs, the CHX and the Pacific Exchange. The Exchange believes its proposed rule change should be granted accelerated approval for the same reasons the Commission determined to approve the standards of those other exchanges.

2. Statutory Basis

The CSE believes that the proposed rule change is consistent with Section 6(b) of the Act¹⁸ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁹ in particular in that it is designed to promote just and equitable principles of trade and 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. Specifically, the proposed rule change will increase competition in PDR markets by permitting Exchange members to compete for PDR order flow. By adopting the proposed rule change, the Exchange will bring the benefits of competition, including increased efficiency and price competition, to those markets.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition.

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

No written comments were either solicited or received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing.

¹⁷The Creation of PDRs in connection with DTC DRS represents the only circumstances under which PDRs can be created in other than Creation Unit size aggregations.

¹⁸ 15 U.S.C. 78f(b).

¹⁹ 15 U.S.C. 78f(b)(5).

¹⁶ PDRs may be created in other than Creation Unit size aggregations in connection with the DTC Dividend Reinvestment Service ("DRS").

Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CSE-97-10 and should be submitted by November 19, 1997.

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

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, with the requirements of Section 6(b)(5).²⁰ The Commission believes that providing for the exchange-trading on CSE of PDRs, in general, and SPDRs and MidCap SPDRs, in particular, will offer investors an efficient way of participating in the securities markets. Specifically, the Commission believes that the trading on CSE of PDRs, in general, and SPDRs and MidCap SPDRs pursuant to unlisted trading privileges, in particular, will provide investors with increased flexibility in satisfying their investment needs by allowing them to purchase and sell a low-cost security replicating the performance of a broad portfolio of stocks at negotiated prices throughout the business day, and by increasing the availability of SPDRs and MidCap SPDRs as an investment tool. The Commission also believes that PDRs will benefit investors by allowing them to trade securities based on unit investment trusts in secondary market transactions.²¹ Accordingly, as

discussed below, the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act that Exchange rules facilitate transactions in securities while continuing to further investor protection and the public interest.²²

As the Commission noted in the orders approving SPDRs and MidCap SPDRs for listing and trading on Amex,²³ the Commission believes that the trading on CSE of a security like PDRs in general, and SPDRs and MidCap SPDRs in particular, which replicate the performance of a broad portfolio of stocks, could benefit the securities markets by, among other things, helping to ameliorate the volatility occasionally experienced in these markets. The Commission believes that the creation of one or more products where actual portfolios of stocks or instruments representing a portfolio of stocks, such as PDRs, can trade at a single location in an auction market environment could alter the dynamics of program trading, because the availability of such single transaction portfolio trading could, in effect, restore the execution of program trades to more traditional block trading techniques.²⁴

An individual SPDR has a value approximately equal to one-tenth of the value of the S&P 500 Index, and an individual MidCap SPDR has a value of approximately one-fifth of the value of the S&P MidCap 400 Index, making them more available and useful to individual retail investors desiring to hold a security replicating the performance of a broad portfolio of stocks. Accordingly, the Commission believes that trading of SPDRs and MidCap SPDRs on CSE will provide retail investors with a cost efficient means to make investment decisions based on the direction of the market as a whole and may provide market participants several advantages over existing methods of effecting program trades involving stocks.

The Commission also believes that PDRs, in general, and SPDRs and MidCap SPDRs, in particular, will provide investors with several advantages over standard open-end S&P 500 Index and S&P MidCap 400 Index mutual fund shares. In particular,

investors will have the ability to trade PDRs continuously throughout the business day in secondary market transactions at negotiated prices.²⁵ In contrast, pursuant to Investment Company Act Rule 22c-1,²⁶ holders and prospective holders of open-end mutual fund shares are limited to purchasing or redeeming securities of the fund based on the net asset value of the securities held by the fund as designated by the board of directors.²⁷ Accordingly, PDRs in general, and SPDRs and MidCap SPDRs in particular, will allow investors to (1) respond quickly to changes in the market; (2) trade at a known price; (3) engage in hedging strategies not currently available to retail investors; and (4) reduce transaction costs for trading a portfolio of securities.

Although PDRs in general, and SPDRs and MidCap SPDRs in particular, are not leveraged instruments, and, therefore, do not possess any of the attributes of stock index options, their prices will still be derived and based upon the securities held in their respective Trusts. In essence, SPDRs are equity securities that are priced off a portfolio of stocks based on the S&P 500 Index and MidCap SPDRs are equity securities that are price off a portfolio of stocks based on the S&P MidCap 400 Index. Accordingly, the level of risk involved in the purchase or sale of a SPDR or MidCap SPDR (or PDR in general) is similar to the risk involved in the purchase or sale of traditional common stock, with the exception that

²⁵ Because of potential arbitrage opportunities, the Commission believes that PDRs will not trade at a material discount or premium in relation to their net asset value. The mere potential for arbitrage should keep the market price of a PDR comparable to its net asset value, and therefore, arbitrage activity likely will be minimal. In addition, the Commission believes the Trust will track the underlying index more closely than an open-end index fund because the Trust will accept only in-kind deposits, and, therefore, will not incur brokerage expenses in assembling its portfolio. In addition, the Trust will redeem in kind, thereby enabling the Trust to invest virtually all of its assets in securities comprising the underlying index.

²⁶ Investment Company Act Rule 22c-1 generally requires that a registered investment company issuing a redeemable security, its principal underwriter, and dealers in that security, may sell, redeem, or repurchase the security only at a price based on the net asset value next computed after receipt of an investor's request to purchase, redeem, or resell. The net asset value of a mutual fund generally is computed once daily Monday through Friday as designated by the investment company's board of directors. The Commission granted SPDRs and MidCap SPDRs an exemption from this provision in order to allow them to trade at negotiated prices in the secondary market. The Commission notes that CSE would need to apply for a similar exemption in the instance that it wishes to list and trade a new PDR because the exemptions are specific to SPDRs and MidCap SPDRs.

²⁷ *Id.*

²⁰ 15 U.S.C. 78f(b)(5).

²¹ The Commission notes, however, that unlike open-end funds where investors have the right to redeem their fund shares on a daily basis, investors could only redeem PDRs in creation unit share sizes. Nevertheless, PDRs would have the added benefit of liquidity from the secondary market and PDR holders, unlike holders of most other open-end funds, would be able to dispose of their shares in a secondary market transaction.

²² In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²³ See *supra* notes 8 and 10.

²⁴ Program trading is defined as index arbitrage or any trading strategy involving the related purchase or sale of a "basket" or group of fifteen or more stocks having a total market value of \$1 million or more.

the pricing mechanism for SPDRs and MidCap SPDRs (and PDRs in general) is based on a basket of stocks. Nonetheless, the Commission has several specific concerns regarding the trading of these securities. In particular, PDRs raise disclosure, market impact, and secondary market trading issues that must be addressed adequately. As discussed in more detail below, and in the Amex Approval Order,²⁸ the Commission believes CSE adequately addresses these concerns.

The Commission believes that the CSE proposal contains several provisions that will ensure that investors are adequately apprised of the terms, characteristics, and risks of trading PDRs. As noted above the proposal contains four aspects addressing disclosure concerns. First, CSE members must provide their customers trading PDRs with a written explanation of any special characteristics and risks attendant to trading such PDR securities (such as SPDRs or MidCap SPDRs), in a form approved by CSE. As discussed above, CSE's filing states that SPDRs and MidCap SPDRs product descriptions should be obtained from Amex.²⁹ The Commission believes that it is reasonable under the Act to allow CSE to require its members to obtain the product description for SPDRs and MidCap SPDRs from Amex.³⁰ Amex might decide to impose a reasonable charge for this service.³¹

Second, members and member organizations must include this written product description with any sales material relating to the series of PDRs

that is provided to customers or the public. Third, any other written materials provided by a member or member organization to customers or the public referencing PDRs as an investment vehicle must include a statement, in a form specified by CSE, that a circular and prospectus are available from a broker upon request. Fourth, a member or member organization carrying an omnibus account for a non-member broker-dealer is required to inform such non-member that execution of an order to purchase a series of PDRs for such omnibus account will be deemed to constitute agreement by the non-member to make the written product description available to its customers on the same terms as member firms. Accordingly, the Commission believes that investors in PDR securities, in general, and SPDRs and MidCap SPDRs, in particular, will be provided with adequate disclosure of the unique characteristics of the PDR instruments and other relevant information pertaining to the instruments. Finally, CSE's Rule 3.7, Recommendations to Customers, will apply to the trading of PDRs, including transactions in SPDRs and MidCap SPDRs.³²

The Commission believes CSE has adequately addressed the potential market impact concerns raised by the proposal. First, CSE's proposal permits listing and trading of specific PDRs only after review by the Commission. Second, CSE has developed policies regarding trading halts in PDRs. Specifically, the Exchange would halt PDR trading if the circuit breaker parameters under CSE Rule 12.11 were reached.³³ In addition, in deciding whether to halt trading or conduct a delayed opening in PDRs, in general, and SPDRs and MidCap SPDRs, in particular, CSE represents that it will be guided by, but not necessarily bound to, whether trading has been halted or suspended in the primary market(s) for any combination of underlying stocks accounting for 20% or more of the applicable current index group value or whether other unusual conditions or circumstances detrimental to the maintenance of a fair and orderly market are present.

³² See *supra* note. 4.

³³ In addition, for PDRs tied to an index, the triggering of futures price limits for the S&P 500 Index, S&P 100 Index, or MMI futures contracts will not, in itself, result in a halt in PDR trading or a delayed opening. However, the Exchange could consider such an event, along with other factors, such as a halt in trading in OEX, SPX, or MMI options, in deciding whether to halt trading in PDRs.

The Commission believes that the trading of PDRs in general on CSE should not adversely impact U.S. securities markets. As to the trading of SPDRs and MidCap SPDR pursuant to UTP, the Commission notes that the corpus of the SPDR Trust is a portfolio of stocks replicating the S&P 500 Index, a broad-based capitalization-weighted index consisting of 500 of the most actively-traded and liquid stocks in the U.S. The corpus of the MidCap SPDR Trust is a portfolio of stocks replicating the S&P MidCap 400 Index, also a broad-based, capitalization-weighted index consisting of 400 actively traded and liquid U.S. stocks. In fact, as described above, the Commission believes SPDRs and MidCap SPDRs may provide substantial benefits to the marketplace and investors, including, among others, enhancing the stability of the markets for individual stocks.³⁴ Accordingly, the Commission believes that SPDRs and MidCap SPDRs do not contain features that will make them likely to impact adversely the U.S. securities markets, and that the addition of their trading on CSE pursuant to UTP could produce added benefits to investors through the increased competition between other market centers trading the product.³⁵

³⁴ Even though PDR transactions may serve as substitutes for transactions in the cash market, and possibly make the order flow in individual stocks smaller than would otherwise be the case, the Commission acknowledges that during turbulent market conditions the ability of large institutions to redeem or create PDRs could conceivably have an impact on price levels in the cash market. In particular, if a PDR is redeemed, the resulting long stock position could be sold into the market, thereby depressing stock prices further. The Commission notes, however, that the redemption or creation of PDRs likely will not exacerbate a price movement because PDRs will be subject to the equity margin requirements of 50% and PDRs are non-leveraged instruments. In addition, as noted above, during turbulent market conditions, the Commission believes PDRs and SPDRs and MidCap SPDRs, in particular, will serve as a vehicle to accommodate and "bundle" order flow that otherwise would flow to the cash market, thereby allowing such order flow to be handled more efficiently and effectively. Accordingly, although PDRs and SPDRs and MidCap SPDRs could, in certain circumstances, have an impact on the cash market, on balance we believe the product will be beneficial to the marketplace and can actually aid in maintaining orderly markets.

³⁵ As mentioned earlier, CSE has represented that it will not begin to trade SPDRs and MidCap SPDRs until they are eligible to trade over ITS. The Commission also reiterates its belief, expressed in the CHX Approval Order, that Amex's statements in its comment letter regarding the trading of SPDRs and MidCap SPDRs through ITS should be resolved, as the Amex letter suggests, through the proper ITS committee, not through Commission action on the CHX (or this) proposal. The Commission does not want to suggest that Amex's concerns are unfounded, but only that the proper venue for their resolution is the proper ITS committee, not the Rule 19b-4 process. See *supra* note 11.

²⁸ See *supra* note. 8.

²⁹ The Commission notes that, in the context of a proposed rule change by CHX to add rules for listing and trading of PDRs in general, and to trade SPDRs and MidCap SPDRs pursuant to UTP, Amex commented on CHX's proposed method regarding the delivery of the SPDR and MidCap SPDR product descriptions, and reserved the right to charge CHX members for supplying the product description should the task become burdensome to Amex. Amex did not object to the underlying policy of CHX members obtaining the product description from Amex. See CHX Approval Order, *supra* note 11.

³⁰ The Commission notes that the exemptions granted by the Commission under the Investment Company Act that permit the secondary market trading of SPDRs and MidCap SPDRs are specifically conditioned upon the customer disclosure requirements described above. Accordingly, CSE rules adequately ensure its members must delivery the current product description to all investors in SPDRs and MidCap SPDRs.

³¹ The Commission notes that Amex would need to file a proposed rule change under Section 19(b) of the Act in the event it decides to charge a fee for supplying the SPDR or MidCap SPDR product descriptions. The Commission notes that reasonable fees would have to be imposed on the member firms rather than the customers entitled to receive the prospectus or the product description.

Finally, the Commission notes that CSE has submitted surveillance procedures for the trading of PDRs, specifically SPDRs and MidCap SPDRs, and believes that those procedures, which incorporate and rely upon existing CSE surveillance procedures governing equities, are adequate under the Act.

The Commission finds that CSE's proposal contains adequate rules and procedures to govern the trading of PDR securities, including trading SPDRs and MidCap SPDRs pursuant to UTP. Specifically, PDRs are equity securities that will be subject to the full panoply of CSE rules governing the trading of equity securities on CSE, including, among others, rules governing the priority, parity and precedence of orders and the responsibilities of specialists. In addition, CSE has developed specific listing and delisting criteria for PDRs that will help to ensure that the markets for PDRs will be deep and liquid. As noted above, CSE's proposal provides for trading halt procedures governing PDRs. Finally, the Commission notes that CSE has stated that Rule 3.7, Recommendations to Customers, will apply to the trading of PDRs in general, and SPDRs and MidCap SPDRs, in particular.

The Commission finds good cause for approving the proposed rule change prior the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that accelerated approval of the proposal is appropriate because it is very similar to CHX's previously approved proposal covering the listing and trading of PDRs in general, and SPDRs and MidCap SPDRs, in particular.³⁶ As such, the Commission believes that the proposed rule change does not raise any new regulatory concerns or issues.

It is therefore ordered, pursuant to Section 19(b)(2)³⁷ that the proposed rule change is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39266; File No. SR-NASD-97-42]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change to Amend NASD Rule 2320(g) to Provide Authority to the Staff of NASD Regulation to Grant Exemptions From Such Provision

October 22, 1997.

I. Introduction

On June 17, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Rule 2320(g) to provide the staff of NASD Regulation authority to grant exemptions from such provision.

Notice of the proposed rule change, together with the substance of the proposal, was published for comment in Securities Exchange Act Release No. 38936 (August 14, 1997), 62 FR 44503 (August 21, 1997). Two comment letters were received on the proposal.³

II. Description

NASD Rule 2320(g) ("The Three Quote Rule" or "Rule") was adopted on May 2, 1998⁴ as an amendment to the NASD's best execution interpretation⁵ under Article III, Section 1 of the NASD's Rules of Fair Practice.⁶ The Three Quote Rule was adopted in connection with the NASD's efforts to develop a nationwide automated market surveillance program for non-Nasdaq, over-the-counter ("OTC") securities, commonly referred to as "pink sheet" stocks, and was designed to create a

¹ 15 U.S.C. 78s(b)(1)

² 17 CFR 240.19b-4.

³ See letter from Leonard Mayer, President, Mayer & Schweitzer, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 12, 1997 ("Mayer letter"), and letter from Paul Chalmers, Senior Vice President, International Trading, Canaccord Capital, to Jonathan G. Katz, Secretary, Commission, dated September 17, 1997 ("Canaccord letter").

⁴ See Securities Exchange Act Release No. 25637 (May 2, 1988), 53 FR 16488 (May 9, 1988).

⁵ "Interpretation of the Board of Governors—Execution of Retail Transactions in the Over-the-Counter Market."

⁶ The best execution interpretation in Article III, Section 1 of the NASD's Rules of Fair Practice was converted into NASD Rule 2320 in connection with the NASD's Manual revision project. See Securities Exchange Act Release No. 36698 (January 11, 1996), 61 FR 1419 (January 19, 1996.)

standard to help assure that members would fulfill their best execution responsibilities to customers in non-Nasdaq securities, especially transactions involving relatively illiquid securities with non-transparent prices.

The Rule expanded a member's best execution obligation to customers by setting forth additional requirements for customer transactions in non-Nasdaq securities. In particular, the Rule requires members that execute transactions in non-Nasdaq securities on behalf of customers to contact a minimum of three dealers (or all dealers if there are three or less) to obtain quotations to enable them to determine the best inter-dealer market. Each member is generally required to use reasonable diligence to ascertain this best inter-dealer market for a security, and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.⁷

Concurrent with these activities, the Commission also approved Schedule H to the NASD's By-Laws, which established an electronic system of mandatory price and volume reporting for the OTC non-Nasdaq securities.⁸ On May 1, 1990, the Commission issued an order approving the operation of the NASD's OTC Bulletin Board Display Service ("OTC Bulletin Board") for a pilot term of one year.⁹ The NASD introduced the OTC Bulletin Board to allow NASD eligible members to enter, update and retrieve quotation information on a real-time basis in non-Nasdaq securities.¹⁰

Since the establishment of the OTC Bulletin Board, significant market, regulatory and technology related improvements have occurred in the non-Nasdaq marketplace.¹¹ In

⁷ See NASD Rule 2320(a).

⁸ Schedule H of the By-laws required NASD members executing principal transactions in non-Nasdaq securities to report price and volume data for the days on which their sales or purchases exceeded 50,000 shares or \$10,000. In 1993, member obligations under Schedule H were modified or eliminated as a result of the NASD adopting real-time reporting of transactions for non-Nasdaq securities. See Securities Exchange Act Release No. 32647 (July 16, 1993), 58 FR 39262 (July 22, 1993).

⁹ On March 31, 1997, the SEC granted permanent approval of the OTC Bulletin Board. See Securities Exchange Act Release No. 38456 (March 31, 1997), 62 FR 16635 (April 7, 1997).

¹⁰ See Securities Exchange Act Release No. 27975 (May 1, 1990), 55 FR 19123 (May 8, 1990).

¹¹ These changes include: requiring that all priced quotations entered by market makers in domestic securities be firm for at least one trading unit (see Securities Exchange Act Release No. 29261 (May 31, 1991), 56 FR 29297 (June 26, 1991)); calculating inside quotes for individual securities and disseminating this information through vendors;

Continued

³⁶ See *supra* note 11.

³⁷ 15 U.S.C. 78s(b)(2).

³⁸ 17 CFR 200.30-3(a)(12).