

the use of an existing separate account of Anchor National to support the Polaris II Contracts. Anchor National filed a new a registration statement on Form N-4 (333-25473) to issue the Contracts through such existing separate account (File No. 811-03859), which was declared effective on May 14, 1997.

3. The Board of Directors of Anchor National authorized the dissolution of Applicant and, pursuant to Arizona Insurance Law, on June 3, 1997, Anchor National nullified the establishment of the Applicant.

4. Applicant has never made a public offering of its securities and does not propose to make a public offering of its securities.

5. Applicant has not held any assets since its establishment.

6. Accordingly, there were no securityholders of Applicant as of the date of the filing of this application; Applicant has not, within the last 18 months, transferred any of its assets to a separate trust, the beneficiaries of which were or are securityholders of Applicant; no distributors were made to securityholders of Applicant in connection with Applicant's dissolution and no assets have been retained by the Applicant.

7. No debts or liabilities of the Applicant remain outstanding.

8. Applicant is not a party to any litigation or administrative proceeding.

9. Applicant has not sold any securities of which it is the issuer and Applicant is not engaged in, and does not propose to engage in, any business activities other than those necessary for the winding-up of its affairs.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39011; File No. SR-CBOE-97-26]

### Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 1 and 2 to the Proposed Rule Change by the Chicago Board Options Exchange, Inc., Relating to Listing and Trading of Regular and Long-Term Index Options and FLEX Options on the Dow Jones Industrial Average

September 3, 1997.

#### I. Introduction

On June 23, 1997, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to list and trade cash-settled, European-style stock index options on the Dow Jones Industrial Average ("DJIA" or "Index"), a broad-based, price-weighted index comprised of 30 large companies traded on the New York Stock Exchange ("NYSE"), as more fully described below. The CBOE is also proposing to trade long-term index options series ("LEAPS®") in the Index as well as flexible exchange options ("FLEX Options") on the Index.

The proposed rule change, together with the substance of the proposal, was published for comment in Securities Exchange Act Release No. 38789 (June 30, 1997), 62 FR 36588 (July 8, 1997). No comment letters were received in response to the proposal. The Exchange subsequently filed Amendment Nos. 1 and 2 to the proposed rule change on

August 12, 1997<sup>3</sup> and August 12, 1997,<sup>4</sup> respectively. This order approves the proposal, as amended, and solicits comments on Amendment Nos. 1 and 2.

#### II. Background and Description

CBOE hereby proposes to amend certain of its rules to provide for the listing and trading on the Exchange of options on the DJIA, a broad-based index designed by Dow Jones & Company, Inc. ("Dow Jones™").<sup>5</sup> Options on the DJIA™ will be cash-settled and will have European-style exercise provisions. The Exchange also proposes to amend its rules to provide for the trading of FLEX Options on the DJIA. The DJIA is a price-weighted index of thirty of the largest, most liquid

<sup>3</sup> Amendment No. 1 states that the Exchange will notify the Commission if any of the following occur: the market value of any component stock is less than \$75 million and that component is not options eligible; less than 80% of the weight of the Index is represented by component stocks that are eligible for options trading; 10% or more of the weight of the index is represented by component stocks trading less than 20,000 shares per day; the largest component stock accounts for more than 15% of the weight of the index or the largest five components in the aggregate account for more than 50% of the weight of the Index; and if the Index decreases to less than 20 component stocks. In addition, Amendment No. 1 amends CBOE Rule 6.42, Interpretation and Policy .03, to provide that the minimum increment for bids and offers for options on the Dow Jones Industrial Average ("DJIA") price at \$3 or above shall be in eighths, unless the Exchange determines that the minimum increment should be reduced to sixteenths. Finally, CBOE has attached to Amendment No. 1 a letter from Dow Jones & Company, Inc. ("Dow Jones") describing its procedures for replacing Index components and stating the conflicts-of-interest policy regarding its employees. See letter from Eileen Smith, Director, Product Development, CBOE, to John Ayanian, Special Counsel, Market Regulation, Commission, dated August 1, 1997 ("Amendment No. 1").

<sup>4</sup> Amendment No. 2 states that with respect to trading DJIA options in increments of sixteenths of a dollar for options greater than \$3, the CBOE Board of Directors will make the determination to allow trading in options on the DJIA in sixteenths. In addition, CBOE will notify members and member firms of the Board's decision to trade DJIA options in sixteenths at least one week prior to implementing the change. Also, CBOE will make a rule change under Section 19(b)(3)(A) of the Act prior to the time the change goes into effect and will make any additional filings necessary to conform its Rules to the fact that trading in DJIA options will take place in sixteenths. Amendment No. 2 also deletes the reference to LEAPS on the DJIA from Rule 24.9(b)(2), the reduced-value LEAPS section, to reflect the fact that there will be no reduced-value LEAPS trading on the DJIA. See letter from Eileen Smith, Director, Product Development, CBOE, to John Ayanian, Special Counsel, Market Regulation, Commission, dated August 8, 1997 ("Amendment No. 2").

<sup>5</sup> "Dow Jones," and "Dow Jones Industrial Average™" are trademarks of Dow Jones & Company, Inc. and have been licensed for use for certain purposes by CBOE. CBOE's options based on the Dow Jones Industrial Average are not sponsored, endorsed, sold or promoted by Dow Jones, and Dow Jones makes no representation regarding the advisability of investing in such products.

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

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

stocks traded on organized U.S. securities markets.<sup>6</sup> Options initially will be based on one-one hundredth of the DJIA. CBOE's proposal also permits it to trade Index options on an underlying level of one-tenth of the value of the DJIA. CBOE indicates, however, that it does not intend to immediately trade such options contracts and states in its rule filing that these contracts may be introduced at a later date. CBOE stated that its purpose in getting approval to trade options based on either one-one-hundredth or one-tenth of the value of the DJIA is to offer contracts which appeal to both retail and institutional investors. If CBOE were to trade options based on both one-one-hundredth and one-tenth the value of the DJIA, each contract would have a different ticker symbol to eliminate any potential confusion.

**Index Design.** The DJIA has been designed to measure the performance of certain high capitalization stocks. The DJIA has been calculated by Dow Jones & Company since 1896 and, according to CBOE, is the most commonly watch index of the U.S. stock market. The DJIA is a price-weighted index with each stock affecting the Index in proportion to its market price. Each stock in the Index is currently trading on the NYSE and is eligible for options trading. All component stocks are "reported securities," as that term is defined in Rule 11Aa3-1 of the Act.<sup>7</sup>

As of June 5, 1997, the 30 stocks in the Index ranged in capitalization from \$5.9 billion to \$200.0 billion. The total market capitalization of the Index was \$1.7 trillion, the average capitalization

of the firms in the Index was \$57.0 billion and the median capitalization was \$40.6 billion. The largest stock accounted for 6.30% of the total weight of the Index, while the smallest accounted for 1.46%. The top 5 components accounted for 26.18% of the weight of the Index. In addition, the average daily trading volume for the component stocks over the six-month period from December 1996 to May 1997 ranged from a high of approximately 8.2 million (Philip Morris) to a low of approximately 515,000 (Goodyear Tire and Rubber Co.).

**Calculation.** The DJIA is a price-weighted index. The level of the Index reflects the total price of the component stocks divided by the Index Divisor. The DJIA was first calculated on May 26, 1896 and the Index value was 40.94 on that date. The Index had a closing value of 7305.29 on June 5, 1997.<sup>8</sup> The daily calculation of the DJIA Index is computed by dividing the aggregate price of the companies in the Index by the Index Divisor. The Divisor keeps the Index comparable over time and is adjusted periodically to maintain the Index. The values of the Index will be calculated by Dow Jones & Company or its designee and will be disseminated at 15-second intervals during regular CBOE trading hours to market information vendors via the Options Price Reporting Authority ("OPRA") or the Consolidated Tape Association ("CTA").

**Maintenance.** Dow Jones is responsible for maintenance of the DJIA. Generally, Index components are replaced infrequently. The Managing Editor of *The Wall Street Journal* is responsible for component additions and deletions. The Managing Editor selects the stocks he believes best reflect the industrial sector of the economy and of the stock market; though various data might be gathered for reference, this is a subjective decision.<sup>9</sup> The stocks are not formally reviewed on any set schedule. Index maintenance includes monitoring and completing the adjustments for company additions and deletions, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to company restructuring or spinoffs. In almost all instances, a stock is removed immediately from the DJIA when the company files for protection under bankruptcy laws. If required, the Index

Divisor will be adjusted to account for any of the above changes. These changes are announced in *The Wall Street Journal* and through the Dow Jones News Service generally three to five days prior to implementation. The DJIA has been composed of 30 stocks since 1928 and it is expected that it will remain at 30 stocks.

In addition, the Exchange will notify the Commission if any of the following occur: the market value of any component stock is less than \$75 million and that component is not options eligible; less than 80% of the weight of the Index is represented by component stocks that are eligible for options trading; 10% or more of the weight of the Index is represented by component stocks trading less than 20,000 shares per day; the largest component stock accounts for more than 15% of the weight of the Index or the largest five components in the aggregate account for more than 50% of the weight of the Index; and the Index decreases to less than 20 component stocks.<sup>10</sup>

**Index Option Trading.** In addition to regular Index options, the Exchange may provide for the listing of long-term Index option series ("LEAPS®"). For LEAPS, the underlying value would be computed by using the same levels as proposed for the Index options; one-tenth or one-one-hundredth of the DJIA, as applicable.<sup>11</sup> The current and closing Index value of any such LEAP will, after such initial computation, be rounded to the nearest one-hundredth.

The Exchange also is proposing to list FLEX Index options on the DJIA. FLEX options give investors the ability, within specified limits, to designate certain of the terms of the options. In recent years, an over-the counter ("OTC") market in customized options has developed which permits participants to designate the basic terms of the options, including size, term to expiration, exercise style, exercise price, and exercise settlement value, in order to meet their individual investment needs. Participants in this OTC market are typically institutional investors, who buy and sell options in large-size transactions through a relatively small number of securities dealers. To compete with this growing OTC market in customized options, the CBOE permits FLEX Index options trading in an exchange auction market environment, with The Options Clearing Corporation ("OCC") as issuer and

<sup>6</sup> The DJIA currently consists of the following companies: Allied Signal, Incorporated; Aluminum Company of America; American Express Company; AT&T Corporation; Boeing Company; Caterpillar, Incorporated; Chevron Corporation; Coca Cola Company; Du Pont de Nemours; Eastman Kodak Company; Exxon Corporation; General Electric Company; General Motors Corporation; Goodyear Tire and Rubber Company; Hewlett Packard Company; IBM International Business Machines; International Paper Company; Johnson and Johnson; JP Morgan and Company, Incorporated; McDonalds Corporation; Merck and Company, Incorporated; Minnesota Mining and Manufacturing; Philip Morris Companies, Incorporated; Procter and Gamble Company; Sears Roebuck and Company; Travelers Group, Incorporated; Union Carbide Corporation; United Technologies Corporation; Wal Mart Stores, Incorporated; and Walt Disney Company.

<sup>7</sup> See 17 CFR 240.11Aa3-1. A "reported security" is defined in paragraph (a)(4) of this rule as "any listed equity security or Nasdaq security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan." A "transaction reporting plan" is defined in paragraph (a)(2) of this rule as "any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in reported securities filed with the Commission pursuant to, and meeting the requirements of, this Section."

<sup>8</sup> The Commission notes that an option on the DJIA, valued at one-one-hundredth of the value of the DJIA, would have a value approximately equal to 73.05, assuming an Index value of 7305.29.

<sup>9</sup> See Amendment No. 1 *supra* note 3.

<sup>10</sup> See Amendment No. 1, *supra* note 3.

<sup>11</sup> The Exchange is not proposing to trade reduced value LEAPS on the DJIA.

guarantor.<sup>12</sup> The Exchange's proposal will allow FLEX option market participants to designate the following contract terms for FLEX options on the DJIA: (1) exercise price; (2) exercise style (*i.e.*, American,<sup>13</sup> European,<sup>14</sup> or capped<sup>15</sup>); (3) expiration date;<sup>16</sup> (4) option type (put, call, or spread); and (5) form of settlement (A.M., P.M. or average).

Strike prices for options based on one-one-hundredth of the Index will be set to bracket the Index in 1/2 point increments or greater. CBOE notes that these 1/2 point increments correspond to 5-point increments in other broad-based index options, such as the Standard & Poor's 100 ("S&P 100") Index and Standard & Poor's 500 ("S&P 500") Index, because the size of the contract will be approximately one-tenth of the size of the option contracts on those other broad-based indexes. Strike prices for options based on one-tenth of the Index will be set in 5-point increments. The trading hours for options on the Index will be from 8:30 a.m. to 3:15 p.m. Chicago time. Options based on the DJIA will be listed in up to three near-term months plus up to three months from the March quarterly cycle.

The Exchange is also proposing to add an interpretation to Rule 6.42 to establish that the minimum increment for bids and offers in the DJIA priced at or above \$3 shall be in eighths of a dollar, unless the Exchange determines that the minimum increment for these options should be reduced to sixteenths of a dollar.<sup>17</sup> Rule 6.42 currently

requires bids and offers to be expressed in eighths of \$1, except for those series trading below \$3. Under CBOE's proposal, the Board of Directors will have the authority to allow the trading of DJIA options in sixteenths of a dollar, and CBOE will notify its members and member firms at least one week prior to implementing such a change. In addition, CBOE will make a rule change filing under Section 19(b)(3)(A) of the Act prior to the time the change goes into effect, and will make any additional filings necessary to conform its Rules to the fact that trading in DJIA options will be changed from increments of eighths to sixteenths of a dollar.<sup>18</sup>

**Exercise and Settlement.** The proposed options on the Index will expire on the Saturday following the third Friday of the expiration month. Trading in the expiring contract month will normally cease at 3:15 p.m. (Chicago time) on the business day preceding the last day of trading in the component securities of the Index (ordinarily the Thursday before expiration Saturday, unless there is an intervening holiday). The exercise settlement value of the Index at option expiration will be calculated by Dow Jones<sup>19</sup> based on the opening prices of the component securities on the business day prior to expiration. If a stock fails to open for trading, the last available price on the stock will be used in the calculation of the Index, as is done for currently listed indexes.<sup>20</sup> When the last trading day is moved because of Exchange holidays (such as when CBOE is closed on the Friday before expiration), the last trading day for expiring options will be Wednesday and the exercise settlement value of Index options at expiration will be determined at the opening of regular Thursday trading.

**Surveillance.** The Exchange will use the same surveillance procedures currently utilized for each of the

Exchange's other index options to monitor trading in Index options and Index LEAPS. In addition, the Exchange will use the same surveillance procedures currently utilized for each of the Exchange's other FLEX index options to monitor trading in FLEX options on the DJIA. 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 23, 1990, will be applicable to the trading of options on the Index.<sup>21</sup>

Dow Jones & Company also has a policy in place to prevent the potential misuse of material, non-public information by members of the Wall Street Journal managerial and editorial staff in connection with the maintenance of the Index. Specifically, the managerial and editorial staff of the Wall Street Journal are subject to the Dow Jones & Company conflicts-of-interest policy which prohibits, upon penalty of dismissal, the use or dissemination of any vital information prior to publication.<sup>22</sup>

**Position Limits.** The Exchange proposes to establish position limits for options on the DJIA at 1,000,000 contracts on either side of the market for option contracts that are based on one-one hundredth of the value of the DJIA and 100,000 for contracts based on one-tenth of the value of the DJIA. Positions in options based on either level of the DJIA will be aggregated for purposes of determining compliance with position limits; positions in options based on one-tenth of the value of the DJIA must be multiplied by a factor of 10, then aggregated with options based on one-one hundredth of the value of the DJIA. The broad-based index hedge exemption will be 2,500,000 contracts for options based on one-one hundredth of the DJIA and 250,000 contracts for options based on one-tenth of the DJIA. These limits are roughly equivalent, in dollar terms, to the limits applicable to options on the S&P 500 Index, a broad-based A.M.-settled index option.

<sup>12</sup> The Commission has previously designated FLEX index options as standardized options for the purposes of the options disclosure framework established under Rule 9b-1 of the Act. See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993). In addition, the Commission has approved the listing by CBOE of FLEX Index options on the S&P 100 ("OEX"), S&P 500 ("SPX"), Nasdaq 100, and Russell 2000 Indexes. See Securities Exchange Act Release Nos. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993) (approval of FLEX options on the SPX and OEX indexes); 34052 (May 12, 1994), 59 FR 25972 (May 18, 1994) (approval of FLEX options on the Nasdaq 100 index); and 32694 (July 29, 1993), 58 FR 41814 (August 5, 1993) (approval of FLEX options on the Russell 2000 index).

<sup>13</sup> An American-style option is one that may be exercised at any time on or before the expiration date.

<sup>14</sup> A European-style option is one that may be exercised only during a limited period of time prior to expiration of the option.

<sup>15</sup> A capped-style index option is one that is automatically exercised prior to expiration when the cap index value is less than or equal to the index value for calls or when the cap index value is greater than or equal to the index value for puts.

<sup>16</sup> The expiration date of a FLEX option may not fall on a day that is on, or within two business days, of the expiration date of a Non-FLEX option.

<sup>17</sup> See Amendment No. 1, *supra* note 3. The Commission notes that the original proposal was to

have a minimum trading increment for all bids and offers in the DJIA, regardless of price, in sixteenths of a dollar.

<sup>18</sup> See Amendment No. 2, *supra* note 4.

<sup>19</sup> Phone conversation between Eileen Smith, Director, Research and Product Development, CBOE, and Heather Seidel, Attorney, Market Regulation, Commission, on June 30, 1997.

<sup>20</sup> The Commission notes that pursuant to Article XVII, Section 4 of the OCC by-laws, OCC is empowered to fix an exercise settlement amount in the event it determines a current index value is unreported or otherwise unavailable. Further, OCC has the authority to fix an exercise settlement amount whenever the primary market for the securities representing a substantial part of the value of an underlying index is not open for trading at the time when the current index value (*i.e.*, the value used for exercise settlement purposes) ordinarily would be determined. See Securities and Exchange Act Release No. 37315 (June 17, 1996), 61 FR 42671 (order approving SR-OCC-95-19).

<sup>21</sup> The 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, dated July 14, 1983, amended January 29, 1990. The members of the ISG are the following: the American Stock Exchange, Inc.; the Boston Stock Exchange, Inc.; the CBOE; 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. The major stock index futures exchanges (including the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

<sup>22</sup> See Amendment No. 1, *supra* note 3.

**FLEX Option Trading.** The Exchange is proposing changes to its FLEX rules to provide for the trading of FLEX options on the DJIA. The proposed changes include an amendment to the FLEX Index option position limits. The change would apply the same limits to positions in FLEX options on the DJIA that exist for positions in other broad-based indexes in the FLEX program; the limits are 200,000 contracts on the same side of the market. For purposes of determining compliance with these limits, every ten option contracts based on the one-one hundredth of the DJIA will be counted as one contract.

**Exchange Rules Applicable.** As modified herein, the Rules in Chapter XXIV will be applicable to options on the DJIA. Broad-based margin rules will apply to the Index. The Exchange is proposing to amend Chapter XXIV, Rule 24.14, Disclaimers, to identify Dow Jones and Company, Inc. as the index reporting authority for the DJIA and other Dow Jones products.

**Capacity.** CBOE believes it has the necessary systems capacity to support new series that would result from the introduction of options on the DJIA. CBOE has also been informed that OPRA also has the capacity to support the new series.<sup>23</sup> In making this determination, the Exchange notes that OPRA has made, and is in the process of making, significant enhancements to its capacity. These enhancements include: upgrades to computers; additional lines to firms, vendors and exchanges; and the introduction of new technology incorporating high speed data transmission. All of these enhancements will be in place prior to the scheduled introduction of these options contracts and will give more than sufficient capacity to deal with these and other new products.

### III. Discussion

The Commission finds that the proposed rule changes are 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).<sup>24</sup> Specifically, the Commission finds that the trading of options on the DJIA, including FLEX options<sup>25</sup> and full-value LEAPS, will serve to promote the public interest as well as to help remove impediments to a free and open securities market. The Commission also believes that the trading of options on

the Index will allow investors holding positions in some or all of the securities underlying the Index to hedge the risks associated with their portfolios. Accordingly, the Commission believes that DJIA Index options will provide investors with an important trading and hedging mechanism.<sup>26</sup> By broadening the hedging and investment opportunities of investors, the Commission believes that the trading of options on the DJIA will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets.<sup>27</sup>

Nevertheless, the trading of options, including FLEX Options and full-value LEAPS, on the DJIA raises several issues related to the design and structure of the Index, customer protection, surveillance, and market impact. The Commission believes, however, for the reasons discussed below, that the CBOE has adequately addressed these issues.

**Index Design and Structure.** The Commission believes that it is appropriate for the Exchange to designate the DJIA as a broad-based index for purposes of index option trading. Specifically, the Commission believes that the Index is broad-based because it reflects a substantial segment of the U.S. equities market. First, the Index represents various diverse segments of the U.S. securities markets, with 19 different industries represented by the Index's components, such as chemicals and allied products, motion picture production, eating and drinking places, transportation equipment, and industrial/commercial machinery and computer equipment. Second, the Index consists of 30 actively-traded stocks that are currently all options eligible.<sup>28</sup>

<sup>26</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new securities product upon a finding that the introduction of such product is in the public interest. Such a finding would be difficult with respect to a product that served no hedging or other economic function, because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed Index options will provide investors with a hedging vehicle that should reflect the overall market of stocks representing a substantial segment of the U.S. securities market.

<sup>27</sup> 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).

<sup>28</sup> See Notice Release. The Exchange's option listing standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 7 million shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume must have been at least 2.4 million shares over the preceding twelve months; and (4) the

Third, the Index, which is designated to track the overall U.S. Market, is composed of highly capitalized, actively traded securities. Specifically, the total capitalization of the Index as of June 5, 1997, was approximately \$1.7 trillion, representing approximately one-fifth of the U.S. equity market. Market capitalization of the individual stocks ranges from \$5.9 billion to \$200 billion, with an average capitalization of \$57 billion. As of the same date, the six-month average daily trading volume for each component in the Index ranged from a low of approximately 515,000 to a high of 8.2 million. Fourth, no stock or group of stocks dominates the Index. Specifically, no single stock accounted for more than 6.30% of the total price weight of the Index, and the five highest weighted securities accounted for 26.18% of the price weight of the Index. Accordingly, the Commission believes that it is appropriate for the Exchange to classify the Index as broad-based and apply its rules governing broad-based index options to trading in the Index options.

The Commission also believes that the general broad diversification, capitalization, and highly liquid markets of the Index's component stocks significantly minimize the potential for manipulation of the Index. First, as discussed above, the Index represents a broad cross-section of domestically traded high capitalization stocks, with no single industry group or stock dominating the Index.<sup>29</sup> Second, all of the stocks that comprise the Index are actively traded. Third, CBOE has represented that it will notify the staff of the Commission when: (1) less than 80% of the weight of the Index is options eligible; (2) 10% or more of the weight of the Index is represented by stocks trading less than 20,000 shares per day; (3) the market capitalization of any component falls below \$75 million at a time the component is not options eligible; (4) the largest component of the Index is greater than 15% of the weight of the Index, or the top five components are greater than 50% of the weight of the Index; or (5) if the Index decreases to less than 20 component stocks.<sup>30</sup> In the

market price per share must have been at least \$7.50 for a majority of business days during the preceding three calendar months. See Interpretation .01 to Exchange Rule 5.3.

<sup>29</sup> The Commission believes that, even though the Index is price weighted, the high capitalization and active trading of the component stocks minimize any manipulative concerns that may arise due to the price weighting.

<sup>30</sup> See Amendment No. 1, *supra* note 3. The Commission recognizes that the capitalization and daily trading volume of the Index's components currently far exceed these standards. Nonetheless,

Continued

<sup>23</sup> See Exhibit D.

<sup>24</sup> 15 U.S.C. 78f(b)(5).

<sup>25</sup> See discussion *infra* regarding FLEX options on the DJIA.

event the Index fails to satisfy any of the criteria, CBOE will notify the Commission to determine the appropriate regulatory response, including but not limited to, prohibiting opening transactions, removal of the securities from the Index, or discontinuing the listing of new series of Index options.<sup>31</sup>

Fifth, the Exchange has proposed reasonable position and exercise limits for the Index options that will serve to minimize potential manipulation and other market impact concerns. The position limits, at 1,000,000 contracts on either side of the market for options valued at one-one-hundredth of the DJIA, are roughly equivalent in dollar terms to the limits applicable to options on other similar indices.<sup>32</sup> Accordingly, the Commission believes these factors minimize the potential for manipulation because it is unlikely that attempted manipulations of the prices of the Index components would affect significantly the Index's value. Moreover, the surveillance procedures discussed below should detect as well as deter potential manipulation and other trading abuses.

**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 DJIA (including full-value FLEX Options and LEAPS), can commence on a national securities exchange. The Commission notes that the trading of standardized, exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) the special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index options, including LEAPS, will be subject to the same regulatory regime as the other standardized options currently traded on the CBOE, the

Commission believes that adequate safeguards are in place to ensure the protection of investors in options on the DJIA.

**Surveillance.** The Commission generally believes that a surveillance-sharing agreement between an exchange proposing to list a stock index derivative and the exchange(s) trading the stocks underlying the derivative product is an important measure for the surveillance of the derivatives and underlying securities markets. Such agreements ensure the availability of information necessary to detect and to deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation.<sup>33</sup> In this regard, the market upon which all of the Index component stocks trade, the NYSE, is a member of the ISG.<sup>34</sup> Similarly, the options on the individual component securities trade on markets which are ISG members.

In addition, the Exchange will apply the same surveillance procedures as those used for existing broad-based index option trading on the CBOE. As noted above, Dow Jones & Company also has a policy in place to prevent the potential misuse of material, non-public information by members of the Wall Street Journal managerial and editorial staff in connection with the maintenance of the Index.<sup>35</sup>

**Market Impact.** The Commission believes that the listing and trading of options, including full-value LEAPS, on the DJIA will not adversely impact the underlying securities markets.<sup>36</sup> First, as described above, the Index is broad-based and comprised of 30 stocks, with no one stock dominating the Index. Second, as noted above, the stocks contained in the Index have large capitalizations and are actively-traded. Specifically, as noted above, the average daily trading volume for the component stocks over the six month period from December 1996 to May 1997 ranged from a high of 8.2 million to a low of 515,000.<sup>37</sup> Third, the 1,000,000 contract position and exercise limits for contracts based on one-one-hundredth

of the value of the DJIA will serve to minimize potential manipulation and market impact concerns. Fourth, currently all stocks comprising the Index are options eligible and CBOE will notify the Commission if less than 80% of the Index continues to be eligible for options trading. Fifth, the risk to investors of contra-party non-performance will be minimized because the Index options and LEAPS will be issued and guaranteed by the OCC, similar to all other standardized options traded in the United States.

Lastly, the Commission believes that settling expiring Index options 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 on closing prices may help reduce adverse effects on markets for stocks underlying options on the Index.<sup>38</sup>

**FLEX Options.** The Commission also believes that the proposal to list DJIA FLEX options should encourage fair competition among brokers and dealers and exchange markets, by allowing the Exchange to compete with the growing OTC market in customized index options.

The Commission believes the Exchange's proposal reasonably addresses its desire to meet the demands of sophisticated portfolio managers and other institutional investors who are increasingly using the OTC market in order to satisfy their hedging needs. Additionally, the Commission believes that the Exchange's proposal will help promote the maintenance of a fair and orderly market, consistent with Sections 6(b)(5) and 11(a) of the Act, because the purpose of the proposal to list DJIA FLEX options is to extend the benefits of a listed, exchange market to index options that are more flexible than current listed options and that currently trade OTC.<sup>39</sup> The benefits of the Exchange's options market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, parameters and procedures for clearance and settlement,

the is similar to minimum maintenance criteria utilized in maintaining a variety of index products to ensure an adequate level of liquidity in the component stocks.

<sup>31</sup> In addition, if the composition of the Index's underlying securities was to substantially change, the Commission's decision regarding the appropriateness of the Index's current maintenance standards would be reevaluated, and whether additional approval under Section 19(b) of the Act is necessary to continue to trade the product.

<sup>32</sup> The Commission notes that although the actual number of contracts is much larger than that of other indexes, the dollar value position and exercise limits are roughly equivalent to similar broad-based indexes, such as the S&P 500 and 100 index options.

<sup>33</sup> See, e.g., Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992) (CBOE-91-51) (order approving the listing of options on the CBOE Biotech Index).

<sup>34</sup> See *supra* note 14.

<sup>35</sup> See Amendment No. 1, *supra* note 3.

<sup>36</sup> In addition, the CBOE has represented that it and OPRA have the necessary systems capacity to support those new series of index options that would result from the introduction of Index options and FLEX Options.

<sup>37</sup> Should 10% or more of the weight of the Index be composed of stocks trading at less than 20,000 per day, CBOE will notify Commission staff. See Amendment No. 1, *supra* note 3.

<sup>38</sup> See, e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (CBOE-92-09) (order approving position limits for European-style Standard & Poor's 500 Stock Index options settled based on the opening prices of component securities).

<sup>39</sup> As noted above, FLEX options allow investors to customize certain terms, including size, term to expiration, exercise style, exercise price, and exercise settlement value.

and the guarantee of OCC for all contracts traded on the Exchange.

The Commission notes that FLEX index options on the DJIA can be constructed with expiration exercise settlement based on the closing values of the component securities, which could potentially result in adverse effects for the markets in these securities.<sup>40</sup> Although the Commission continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Friday helps alleviate stock market volatility,<sup>41</sup> these market impact concerns are reduced in the case of FLEX options on the DJIA because expiration of these options will not correspond to the normal expiration of any Non FLEX options (including options overlying the DJIA), stock index futures, and options on stock index futures. In particular, FLEX options, will never expire on any "Expiration Friday," because under CBOE rules the expiration date of a FLEX option may not occur on a day that is on, or within, two business days of the expiration date of a Non-FLEX option. The Commission believes that this should reduce the possibility that the exercise of FLEX options at expiration will cause any additional pressure on the market for underlying securities at the same time Non-FLEX options expire.

Nevertheless, because the position limits for FLEX index options on the DJIA are much higher than those currently proposed for the corresponding non-FLEX Index options and open interest in one or more FLEX options on the DJIA might have an impact on the securities markets for the securities underlying FLEX options. The Commission expects the Exchange to monitor the actual effect of FLEX options on the DJIA once trading commences and take prompt action (including timely communication with the self-regulatory organizations responsible for oversight of trading in the underlying securities) should any unusual market effects develop.

**Accelerated Approval of Amendment Nos. 1 and 2.** The Commission finds good cause to approve Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, by stating that CBOE will notify the Commission in certain circumstances regarding the weighting, capitalization, and number of DJIA component stocks, specified above, and by describing Dow

Jones procedures for replacing component stocks, Amendment No. 1 will help to ensure that the Commission receives adequate notice of material changes in component stocks of the DJIA.

Amendment Nos. 1 and 2 also amend Interpretation and Policy .03 under CBOE Rule 6.42 to specify that the DJIA options priced at \$3 or above will be traded in eighths of a dollar, unless the CBOE Board of Directors determines that the minimum increment shall be sixteenths of a dollar; CBOE will give at least one week notice to its members and member firms prior to implementing such a change and will file any proposed rule changes necessary to conform its rules to such a change. This portion of Amendment Nos. 1 and 2 clarifies the minimum trading increment for DJIA options and the procedure by which CBOE, through its Board, can modify that increment. It also ensures that investors will have adequate notice of any changes in the trading increments as well as that proposed rule change(s) under Section 19(b) of the Act will be filed with the Commission as appropriate. The Commission further believes that these proposed amendments raise no new regulatory issues. Finally, the Commission notes that no comments were received on the original CBOE proposal, which was subject to the full 21-day notice and comment period. Accordingly, the Commission believes that it is consistent with Sections 6(b)(5) and 19(b)(2) of the Act to approve Amendment Nos. 1 and 2 to the proposal on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments Nos. 1 and 2 to the rule proposal. 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 also will be available for inspection and copying at the principal office of the Exchange. All

submissions should refer to File No. SR-CBOE-97-26 and should be submitted by October 2, 1997.

#### V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>42</sup> that the proposed rule change (SR-CBOE-97-26) including Amendment Nos. 1 and 2, is approved. In addition, for purposes of trading FLEX Options on the Index, the Commission also finds, pursuant to Rule 9b-1 under the Act, that such options are standardized options for purposes of the options disclosure framework established under Rule 9b-1.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>43</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39013; File No. SR-CBOE-97-28]

#### Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to Proposed Rule Change Relating to Listing of Regular Options, Full and Reduced Value Long-Term Index Options, and FLEX Options on the Dow Jones Utility Average

September 3, 1997.

#### I. Introduction

On June 23, 1997, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to list regular options, full and reduced value long-term index options ("LEAPS"), and flexible exchange options ("FLEX") on the Dow Jones Utility Average.

The proposed rule change was published for comment in the **Federal Register** on July 8, 1997.<sup>3</sup> No comments were received on the proposal. On August 12, 1997, the CBOE submitted

<sup>42</sup> 15 U.S.C. 78s(b)(2).

<sup>43</sup> 17 CFR 200.30-3(a) (12) and (51).

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

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

<sup>3</sup> Securities Exchange Act Release No. 38790 (June 30, 1997), 62 FR 36592 (July 8, 1997).

<sup>40</sup> See, e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

<sup>41</sup> *Id.*