

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41009; File No. SR-CBOE-98-49]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; 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 Trading and Listing Options on the Dow Jones Equity REIT Index

February 1, 1999.

I. Introduction

On November 5, 1998 the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to provide for the listing and trading of options on the Dow Jones Equity Real Estate Investment Trust Index ("Index" or "REITS Index"). The Commission published the proposed rule change for comment in the *Federal Register* on December 22, 1998.³ No comments were received.

On January 28, 1999, the CBOE submitted Amendment No. 1 to the proposed rule change.⁴ This order approves the proposed rule change, and also approves Amendment No. 1 on an accelerated basis.

II. Description of the Proposal

A. Index Design

The proposed rule change would permit the Exchange to list and trade cash-settled, European-style,⁵ A.M.-settled stock index options. The Index is a broad-based, capitalization-weighted index currently composed of 116 equity

real estate investment trusts ("REITs").⁶ The Index was designed by Dow Jones & Company. The Index has been designed to measure the performance of REITs that comprise 95% of the market capitalization of the domestic equity REIT investable universe, which includes equity REITs that are listed on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("Amex") and the Nasdaq National Market ("NNM").

The Index components are subject to a screening process that: (1) eliminates REITs that have more than 10 no-trading days over the past quarter; (2) eliminates REITs that comprise the bottom 1% of the aggregate REIT market capitalization; and (3) eliminates REITs that comprise the bottom 0.01% of the average dollar-trading volume. All of the component REITs are "reported securities," as that term is defined in Rule 11Aa3-1 under the Act.⁷ All but one REIT in the Index are eligible for options trading.

On October 20, 1998, the 116 components ranged in capitalization from \$207 million to \$6.13 billion. The largest component accounted for 5.08% of the total weighting of the Index, while the smallest accounted for 0.17%. The total capitalization of the REITs in the Index was \$120.4 billion. The average capitalization was \$1.04 billion, and the median capitalization was \$655 million. Also, as of October 20, 1998, the Index components represented eleven distinct property classifications: office property (21.01%), apartments (19.31%), shopping centers (12.27%), hotels/restaurants (9.33%), regional malls (9.17%), diversified (8.56%), warehouses/industrial (7.53%), healthcare (5.35%), self-storage (4.99%), manufactured homes (1.65%) and outlet centers (0.83%). In addition, the Index components are diversified by geographic region, representing real estate investments throughout much of the United States.

B. Index Value Calculation

The methodology used to calculate the value of the Index is similar to the

methodology used to calculate the value of other well-known broad-based indices. The level of the Index reflects the total market value of the component REITs relative to a particular base period. The Index base date is January 2, 1990, when the Index value was set to 100. The Index had a closing value of 131.44 on October 19, 1998. The daily calculation of the Index is computed by dividing the total market value 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, Inc. or its designee and disseminated at 15-second intervals during regular CBOE trading hours to market information vendors via the Options Price Reporting Authority ("OPRA").

C. Index Maintenance

Dow Jones or its designee is responsible for the maintenance of the Index. Index maintenance includes monitoring and completing the adjustments for company additions and deletions, share changes, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to company restructuring or spin-offs. Some corporate actions, such as stock splits and stock dividends, require simple changes in the common shares outstanding and the stock prices of the companies in the Index. Other corporate actions, such as share issuances or component changes, may change the market value of the Index and require an index divisor adjustment as well.

The Index is reviewed on a quarterly basis by adding or deleting REITs using end-of-quarter market capitalization values. If any component REIT fails to meet the targeted threshold or the investable universe cutoff rules, it will be deleted from the Index. Non-component REITs that become eligible for inclusion are added, largest to smallest, until the 95% threshold is attained. In order to preserve the continuity of the Index, the actual threshold may be slightly higher or lower than the targeted 95%. An annual review is performed to update any changes in an issue's investment structure and/or property type. As a result of these periodic reviews, over time the number of component REITs in the Index may change.

The Exchange will notify the Commission if the number of securities in the Index drops by 40 or more. In addition, the Exchange will notify the Commission if any of the following occurs: 10% or more of the weight of the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 40794 (December 15, 1998), 63 FR 70816.

⁴ See letter, dated January 27, 1999, from Eileen Smith, Director, Product Development, CBOE, to Marianne Duffy, Special Counsel, Division of Market Regulation, Commission ("Amendment No. 1"). Among other things, Amendment No. 1 clarified that the Dow Jones' internal surveillance procedures apply to the Index as well, included the full list of the Index components, amended Rule 24.4.01(e) to include a hedge exemption of 625,000 contracts on the Index and clarified that the maintenance standard of 80% is by weight.

⁵ A European-style option is one that may be exercised only during a limited period of time prior to expiration of the option.

⁶ REITs, created by the U.S. Congress to facilitate small investor participation in real estate on a wholesale scale, pool capital from multiple investors like mutual funds.

⁷ See 17 CFR 240.11Aa3-1. A "reported security" is defined as "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan." A "transaction reporting plan" is in turn 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."

Index is represented by component REITs having a market value less than \$75 million; less than 80% of the weight of the Index is represented by component REITs that are eligible for options trading; 10% or more of the weight of the Index is represented by component REITs trading less than 20,000 shares per day; the largest component REIT 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.

D. Index Option Trading

In addition to regular Index options, the Exchange may provide for the listing of long-term index option series ("LEAPs") and reduced-value LEAPs on the Index. For reduced-value LEAPs, the underlying value would be computed at one-tenth of the Index level. The current and closing index value of any such reduced-value LEAP will, after such initial computation, be rounded to the nearest one-hundredth.

Strike prices will be set to bracket the Index in 2½ point increments for strikes below 200 and 5 point increments above 200. The minimum tick size for series trading below \$3 will be ¼¢ and for series trading above \$3 the minimum tick will be ⅛¢. The trading hours for options on the Index will be from 8:30 a.m. to 3:02 p.m. (Chicago time).

E. 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 3:02 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 or its' designee based on the opening prices of the component securities on the business day prior to expiration. If a REIT fails to open for trading, the last available price will be used in the calculation of the Index, as is done for currently listed indices.⁸

⁸The Commission notes that pursuant to Article XVII, Section 4 of the by-laws of the Options Clearing Corporation ("OCC"), 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

When the last trading day is moved because of Exchange holidays (such as when the 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.

F. Surveillance and Position Limits

The Exchange will use the same surveillance procedures currently utilized for each of the Exchanges' other index options to monitor trading on options and LEAPs on the Index. For surveillance purposes, the Exchange will have complete access to information regarding trading activity in the underlying securities.

The Exchange proposes to establish position limits for options on the Index at 250,000 contracts on either side of the market. These limits are roughly equivalent, in dollar terms, to the limits applicable to options on other indices.

G. Exchange Rules Applicable

As modified by this proposal, the Rules in Chapter XXIV will be applicable to the Index options. Broad-based margin rules will apply to the Index. In addition, the Index will have a broad-based index hedge exemption of 625,000 contracts. CBOE is proposing to amend Rule 24.14 in order to include specific reference to Dow Jones & Company, Inc. as being entitled to the benefit of the disclaimer of liability in respect of the Index.

H. Systems Capacity

CBOE believes it has the necessary systems capacity to support new series that would result from the introduction of the Index options. CBOE also has been assured that the OPRA has the capacity to support the new series.

III. Discussion

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).⁹ Specifically, the Commission finds that the trading of options on the REIT Index, including LEAPs and reduced-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

be determined. See Securities Exchange Act Release No. 37315 (June 17, 1996), 61 FR 42671 (Commission order approving SR-OCC-95-19).

⁹ 15 U.S.C. 78f(b)(5).

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 the Index options will provide investors with an important trading and hedging mechanism.¹⁰ By broadening the hedging and investment opportunities of investors, the Commission believes that the trading of options on the REIT Index will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets.¹¹

Nevertheless, the trading of options on the REIT Index 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.¹²

A. Index Design and Structure

The Commission believes that it is appropriate for the Exchange to designate the Index as a broad-based index for purposes of index option trading because the REIT segment of the U.S. equities market constitutes a substantial segment of the overall public U.S. equities market and the Index reflects the REIT market.¹³ First, the

¹⁰ 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.

¹¹ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹² The Commission notes that it did not object to the designation of the Chicago Mercantile Exchange as a contract market to trade futures and futures options on the Standard and Poor's REIT Composite Index. See letter, dated November 23, 1998, from Richard R. Lindsey, Director, Division of Market Regulation, Commission, to Steven Manaster, Director, Division of Economic Analysis, Commodity Futures Trading Commission. This index consisted of 105 REIT stocks, most of which also are the components of the Index, and had a similar market capitalization.

¹³ The REIT segment is recognized as a discernible, unique segment of the overall market that operates, in part, as a vehicle for equity market participants to hold indirect interests in real estate. During this decade, the REIT segment of the U.S. equities market has grown to 210 REITs with a market capitalization of approximately \$140 billion

Index consists of 116 component REITs, and incorporates approximately 95% of the REIT industry measured by capitalization. These 116 securities are diverse, representing a broad cross-section of the REIT segment of the U.S. market. Second, all of the component REITs are reported securities, and all but one REIT in the Index are eligible for options trading.¹⁴ Third, no stock or group of stocks dominates the Index. Specifically, no single REIT accounted for more than 5.08% of the total weighting of the Index, and the five highest weighted securities accounted for 19.02%. 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.

B. Potential for Manipulation

The Commission also believes that the large number of components, the capitalization and weighting methodology of the Index, and the depth and liquidity of the securities comprising the Index significantly minimize the potential for manipulation of the Index. First, the Commission notes that the REIT Index is composed of 116 securities which represent a broad cross-section of the REIT segment of the U.S. market. Second, the Commission notes that the Index is a capitalization-weighted index whose value is more difficult to affect than that of a price-weighted index. Third, CBOE has represented that it will notify the Commission when: (1) the number of securities in the Index drops by 40 or more; (2) 10% or more of the weight of the Index is represented by component REITs having a market value less than \$75 million; (3) less than 80% of the weight of the Index is represented by component REITs that are eligible for options trading; (4) 10% or more of the weight of the Index is represented by component REITs trading less than

20,000 shares per day; or (5) the largest component REIT 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.¹⁵ Fourth, 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. Accordingly, the Commission believes that 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.

C. 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 Index including LEAPS and reduced-value LEAPs, can commence on a national securities exchange. The Commission notes that the trading of standardized, exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) the special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because 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 Index.

D. 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.¹⁶ In this regard, the markets upon which all of the Index component stocks trade, the NYSE, Amex and NNM, are members of the ISG. In addition, the Exchange will apply the same surveillance procedures as those used for existing broad-based index option trading on the CBOE. Furthermore, 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.¹⁷

E. Market Impact

The commission believes that the listing and trading of options, including LEAPS and reduced-value LEAPs, on the Index will not adversely affect the underlying securities markets.¹⁸ First, as described above, the Index is broad-based and constituted of 116 REIT stocks, with no one stock dominating the Index. Second, the position limit of 250,000 contracts on either side of the market and exercise limit of 250,000 contracts based on the value of the Index will serve to minimize potential manipulation and market impact concerns. Third, currently all components except one REIT 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. Fourth, the risk to investors of contra-party one-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

as of October 30, 1998. See National Association of Real Estate Investment Trusts (<http://www.nareit.com>). The REIT segment has also evolved into a diverse segment, with numerous REITs holding a variety of investments including healthcare, office, residential, retail, self-storage, hotel/restaurants, shopping centers and diversified use properties.

¹⁴ 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 market price per share must have been at least \$7.50 for a majority of business days during the preceding three calendar months. See Interpretations and Policies .01 to Exchange Rule 5.3.

¹⁵ If the composition of the Index was to substantially change, the Commission may reevaluate its decision regarding the appropriateness of the Index's current maintenance standards and may consider whether additional approval under Section 19(b) of the Act is necessary to continue to trade the Index options.

¹⁶ See e.g., Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992) (order approving the listing of options on the CBOE Biotech Index).

¹⁷ See Amendment No. 1, *supra* note 4.

¹⁸ 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.

stocks underlying options on the Index.¹⁹

F. Accelerated Approval of Amendment No. 1

The Commission finds good cause to approve Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission notes that Amendment No. 1 does not change, but rather clarifies, the proposed rule change, and thus does not raise any new regulatory issues. Specifically, among other things, Amendment No. 1 clarified that the Dow Jones' internal surveillance procedures apply to the Index as well, included the full list of the Index components, amended Rule 24.4.01(e) to include a hedge exemption of 625,000 contracts on the Index, and clarified that the maintenance standard of 80% is by weight. In addition, 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 No. 1 to the proposal on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1 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-98-49 and should be submitted by March 2, 1999.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁰ that the proposed rule change (SR-CBOE-98-49), including Amendment No. 1, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40982; File No. SR-CSE-99-01]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Cincinnati Stock Exchange, Inc., Relating to Mandatory Year 2000 Testing

January 26, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934,¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 26, 1999 the Cincinnati Stock Exchange, Incorporated ("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 CSE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to approve the proposal on an accelerated basis.

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

The Exchange proposes to adopt new Rule 4.5, *Mandatory Year 2000 Testing*, that would require member firms to participate in testing of computer systems designed to prepare for Year 2000 and to file reports regarding the testing with the Exchange.

The text of the proposed rule change is below. Proposed new language is italicized.

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CHAPTER IV

Books and Records

Rule 4.5 Mandatory Year 2000 Testing

This rule will expire automatically on January 1, 2001.

(a) *Point-to-Point Testing. Each member that has an electronic interface with the Exchange shall participate in point-to-point testing with the Exchange of its computer systems designed to ascertain Year 2000 compatibility of those computer systems, in a manner and frequency as prescribed by the Exchange. A member that has its electronic interface through a service provider need not participate in point-to-point testing if, by a time designated by the Exchange, (i) the service provider conducts successful tests with the Exchange on behalf of the firms it serves, (ii) the member conducts successful point-on-point testing with the service provider, and (iii) the Exchange agrees that further testing is not necessary.*

(b) *Industry-Wide Testing. The Exchange may require certain of its members to participate in industry-wide testing of computer systems for Year 2000 compatibility. The Exchange may require any member who will participate in industry-wide testing to also participate in any tests necessary to ensure preparedness to participate in industry-wide testing.*

(c) *Reports. Members participating in point-to-point testing (whether between the firm and the Exchange, between the firm and its service provider, or between the firm's service provider and the Exchange) or industry-wide testing shall file reports with the Exchange concerning the required tests in the manner and frequency required by the Exchange. The Exchange may require reports before the testing is begun to ensure that the member or its service provider is prepared to participate in the tests.*³

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

In its filing with the Commission, CSE 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 place specified in Item IV below. The CSE has prepared

¹⁹ See e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (order approving position limits for European-style Standard & Poor's 500 Stock Index options settled based on the opening prices of component securities).

²⁰ 15 U.S.C. 78s(b)(2).

²¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Technical corrections to the rule language were made during a telephone conversation between Robert Ackerman, Vice President Regulatory Services, CSE, and Joshua Kans, Attorney, Division of Market Regulation, Commission, January 26, 1999.