

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 240 and 249

[Release No. 34-39885; File No. S7-13-98]

RIN 3235-AH39

### Proposed Amendment to Rule 19b-4, Under the Securities Exchange Act of 1934, That Would Deem the Listing and Trading of New Derivative Securities Products by Self-Regulatory Organizations To Not Be Proposed Rule Changes

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

**SUMMARY:** The Securities and Exchange Commission proposes to amend Rule 19b-4 under the Securities Exchange Act of 1934. The amendment would expand the scope of SRO matters that do not constitute proposed rule changes to include the listing and trading of new derivative securities products pursuant to existing SRO trading rules, procedures, surveillance programs and listing standards.

**DATES:** Comments should be submitted by May 29, 1998.

**ADDRESSES:** All comments should be submitted in triplicate and addressed to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Mail Stop 6-9, 450 Fifth Street, NW., Washington, DC 20549. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comments should refer to File No. S7-13-98; this file number should be included in the subject line if e-mail is used. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room at the same address. Electronically submitted comment letters will be posted on the Commission's web site (<http://www.sec.gov>).

**FOR FURTHER INFORMATION CONTACT:** Sharon M. Lawson, Senior Special Counsel at (202) 942-0182 or Marianne H. Duffy, Special Counsel at (202) 942-4163, Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, Mail Stop 10-1, 450 Fifth Street, NW., Washington, DC 20549.

#### SUPPLEMENTARY INFORMATION:

#### I. Introduction

##### A. Purpose of Amendment

The Securities and Exchange Commission ("SEC" or "Commission") is proposing to amend Rule 19b-4 under the Securities Exchange Act of 1934, as

amended ("Exchange Act" or "Act")<sup>1</sup> to expand the scope of self-regulatory organization ("SRO")<sup>2</sup> matters that do not constitute proposed rule changes, pursuant to section 19(b) of the Act and Rule 19b-4<sup>3</sup> thereunder, to include the listing and trading of certain new derivative securities products, as defined below, pursuant to existing trading rules, procedures, surveillance programs and listing standards.

##### B. Description of Proposed Amendment

Section 19(b) of the Exchange Act requires every SRO to file with the Commission any proposed rule or any proposed change in the rules of the SRO. In the past, the Commission has considered the listing and trading of new derivative securities products by an SRO to constitute a proposed rule change. In order to approve these changes, the Commission must find that the listing and trading of the new derivative securities product will serve to promote the public interest and help to remove impediments to a free and open securities market.<sup>4</sup> Further, the trading of such new derivative securities products must serve to protect investors and promote efficiency, competition and capital formation.

The Commission has exercised its rulemaking authority<sup>5</sup> by promulgating paragraphs (b),<sup>6</sup> (c)<sup>7</sup> and (d)<sup>8</sup> of Rule 19b-4 under the Act, which interpret the terms "stated policy, practice or

interpretation" and "proposed rule change." Paragraph (c) of Rule 19b-4 provides that certain stated policies, practices and interpretations of SROs do not constitute proposed rule changes. Specifically, a "stated policy, practice or interpretation" of an SRO is not a proposed rule change if it is reasonably and fairly implied by an existing SRO rule. The Commission now proposes to amend Rule 19b-4 so that the listing and trading of new derivative securities products would not be proposed rule changes so long as there are existing SRO trading rules, procedures, surveillance programs and listing standards. Specifically, the Commission proposes to add a new paragraph (e) to Rule 19b-4 which states:

the listing and trading of a new derivative securities product by (an SRO) shall not be deemed a proposed rule change, pursuant to paragraph (c)(1) of (Rule 19b-4), if the Commission has approved, pursuant to section 19(b) of the Act ( ), such (SRO's) trading rules, procedures and listing standards for the product class that would include the new derivative securities product, and the SRO has a surveillance program for the product class.<sup>9</sup>

In proposing new paragraph (e), the Commission preliminarily believes that when the Commission has approved, pursuant to section 19(b) of the Act, an SRO's trading rules, procedures and listing standards for the product class that would include the new derivative securities product, the listing and trading of the new derivative securities product is reasonably and fairly implied by the SRO's existing trading rules, procedures and listing standards. The Commission preliminarily believes it is therefore appropriate to deem the listing and trading of new derivative securities products to not be proposed rule changes pursuant to Rule 19b-4(c)(1) under certain conditions.

#### II. Background

##### A. Current Procedures for Submission and Approval of SRO New Derivative Securities Product Rule Filings

Over the years, the Commission has sought to revise the rule filing requirements to meet the changing needs of the SROs in a competitive international marketplace. The Commission has developed streamlined filing procedures to ease the regulatory burden in many circumstances. Today, the Commission is proposing to expand the scope of SRO matters that do not constitute proposed rule changes to include the listing and trading of new derivative securities products pursuant to existing SRO trading rules,

<sup>1</sup> 15 U.S.C. 78a et seq.

<sup>2</sup> Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26), defines SRO to mean any national securities exchange, registered securities association, registered research agency, and for purposes of Section 19(b) of the Act, 15 U.S.C. 78s(b), and other limited purposes, the Municipal Securities Rulemaking Board ("MSRB").

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> 15 U.S.C. 78f(b)(5).

<sup>5</sup> Sections 3(a)(26), 3(a)(27), 15 U.S.C. 78c(a)(27), 3(a)(28), 15 U.S.C. 78c(a)(28) and section 3(b), 15 U.S.C. 78c(b), of the Act provide that the Commission may promulgate rules regarding, among other things, "stated policies, practices and interpretations" of SROs. Section 19(b) authorizes the Commission to promulgate rules regarding "proposed rule changes" of SROs. Section 23(a), 15 U.S.C. 78w(a), of the Act provides that the Commission shall have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of the Exchange Act for which it is responsible or for the execution of the functions vested in it by the Exchange Act, and may for such purposes classify persons, securities, transactions, statements, applications, reports and other matters within its jurisdiction, and prescribe greater, lesser or different requirements for different classes thereof. (See e.g., Securities Exchange Act Release No. 34140 (June 1, 1994), 59 FR 29393 (June 7, 1994)). In addition, in 1996, Congress granted the Commission the authority, under section 36(a), 15 U.S.C. 78mm(a), to exempt any class of person, security or transaction from any provision of the Act. Pub. L. 104-290, 110 Stat. 3416 (1996).

<sup>6</sup> 17 CFR 240.19b-4(b).

<sup>7</sup> 17 CFR 240.19b-4(c).

<sup>8</sup> 17 CFR 240.19b-4(d).

<sup>9</sup> See *Text of the Proposed Rule*, infra.

procedures, surveillance programs and listing standards.

### 1. Standard Statutory Procedures

Section 19(b)(1) <sup>10</sup> of the Act requires an SRO to file with the Commission its proposed rule changes accompanied by a concise general statement of the basis and purpose of the proposed rule change. Once a proposed rule change has been filed, the Commission is required to publish notice of it and provide an opportunity for public comment. The proposed rule change may not take effect unless it is approved by the Commission or is otherwise permitted to become effective under section 19(b) of the Act. <sup>11</sup> Section 19(b)(2) <sup>12</sup> of the Act sets forth the standards and time periods for Commission action either to approve a proposed rule change or to institute and conclude a proceeding to determine whether a proposed rule change should be disapproved. Generally, the Commission must either approve the proposed rule change or institute disapproval proceedings within 35 days of the publication of notice of the filing or within a longer period as the Commission finds appropriate or to which the SRO consents. The Commission must approve a proposed rule change if it finds that the rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the SRO proposing the rule change. If the Commission does not make that finding, it must institute proceedings to determine whether to disapprove the proposed rule change. The Commission also may approve a proposed rule change on an accelerated basis prior to 30 days after publication of the notice if the Commission finds good cause for so doing and publishes its reasons for so finding. <sup>13</sup>

SROs have submitted proposals under section 19(b)(2) to list and trade various derivative securities products, including stock options, broad-based and narrow-based stock index options <sup>14</sup> and

warrants, <sup>15</sup> unit investment trusts, <sup>16</sup> foreign currency options, <sup>17</sup> indexed term notes <sup>18</sup> and other hybrid derivative equity and debt securities. <sup>19</sup>

### 2. Streamlined Procedures for Certain New Derivative Securities Product Rule Filings

Section 19(b)(3) of the Act <sup>20</sup> provides that, in certain circumstances, a proposed rule change may become effective immediately upon filing with the Commission and without the notice and approval procedures required by section 19(b)(2). Paragraph (A) of section 19(b)(3) permits certain types of proposed rule changes to take effect in this manner if appropriately designated by the SRO as: (1) Constituting a stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO; (2) establishing or changing a due, fee, or other charge imposed by the SRO; or (3) concerned solely with the administration of the SRO. Section 19(b)(3)(A)(iii) <sup>21</sup> also gives the Commission the authority to expand, by rule, the scope of proposed rule changes that may become effective under section 19(b)(3)(A) if the Commission determines that the expansion is consistent with the public interest and the purposes of Section 19(b). Currently, Rule 19b-4(e) under the Act <sup>22</sup> details the scope of proposed rule changes that

may be filed under section 19(b)(3)(A) of the Act.

For the past several years, the Commission has worked with the SROs to develop procedures to streamline the review process of new derivative securities product rule filings. As a result, SROs can submit a proposed rule change in accordance with section 19(b)(3)(A) of the Act for certain proposed new derivative securities products. For example, on June 3, 1994, the Commission approved proposed rule changes submitted by several SROs to establish generic listing standards for options on narrow-based stock indices and to adopt streamlined procedures for introducing trading in options that satisfy these listing standards. <sup>23</sup> In addition, certain SROs have in place rules similar to the streamlined procedures for listing warrants on narrow-based stock indices. <sup>24</sup>

Furthermore, the Commission has approved rules for certain SROs that allow for the listing of specific broad-based <sup>25</sup> and narrow-based <sup>26</sup> stock index warrant issuances without further Commission approval pursuant to section 19(b) of the Act, as long as the listing complies with the SRO's generic warrant listing standards and the Commission has already approved the underlying stock index for warrant or

(June 5, 1997) (order approving American Stock Exchange's, Incorporated ("Amex") proposal to list and trade options based on the the Tobacco Index).

<sup>15</sup> See e.g., Securities Exchange Act Release No. 39079 (September 15, 1997), 62 FR 49543 (September 22, 1997) (order approving Amex proposal to list and trade warrants based on the ING Barings, Inc.'s BEMI Latin American Index).

<sup>16</sup> Securities Exchange Act Release No. 31591 (December 11, 1992), 57 FR 60253 (December 18, 1992) (order approving Amex rules to provide for the listing and trading of portfolio depositary receipts ("PDRs"), and specifically PDRs based on the Standard and Poors Corporation ("S&P") 500 Index known as SPDRs). See also, Amex Rule 1000(b)(1).

<sup>17</sup> See e.g., Securities Exchange Act Release No. 36505 (November 22, 1995), 60 FR 61277 (November 29, 1995) (order approving Philadelphia Stock Exchange's, Incorporated ("Phlx") proposal to list and trade dollar-denominated delivery foreign currency options on the Japanese Yen).

<sup>18</sup> See e.g., Securities Exchange Act Release No. 37533 (August 7, 1996), 61 FR 42075 (August 13, 1996) (order approving Amex proposal to list and trade indexed term notes based upon a portfolio of the top ten dividend yielding stocks in the Dow Jones Industrial Average).

<sup>19</sup> See e.g., Securities Exchange Act release No. 32950 (September 23, 1993), 58 FR 50985 (September 29, 1993) (order approving New York Stock Exchange's, Incorporated ("NYSE") proposal to list and trade Debt Exchangeable for Common Stock issued by the American Express Corporation and linked to the performance of First Data Corporation).

<sup>20</sup> 15 U.S.C. 78s(b)(3).

<sup>21</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>22</sup> 17 CFR 240.19b-4(e).

<sup>23</sup> Securities Exchange Act Release No. 34157 (June 3, 1994) 59 FR 30062 (June 10, 1994) (order approving generic narrow-based index options listing standards for the Amex, the CBOE, the NYSE, the Pacific Exchange, Inc., ("PCX"), and the Phlx ("Generic Narrow-Based Index Option Approval Order")). Moreover, as of April 28, 1997, the NYSE transferred its options business to the CBOE. See Securities Exchange Act Release Nos. 38541 and 38542 (April 23, 1997) 62 FR 23516 and 23521 (April 30, 1997) (orders approving proposed rule changes by the CBOE and NYSE, respectively, regarding the transfer of the NYSE's options business to the CBOE). These SROs are the only U.S. exchanges that list standardized options products, which are issued, cleared, and settled through the Options Clearing Corporation.

<sup>24</sup> Securities Exchange Act Release Nos. 37007 (March 21, 1996) 61 FR 14165 (March 29, 1996) (Amex, CBOE, and Phlx) and 37445 (July 16, 1996) 61 FR 38494 (July 24, 1996) (NYSE) (orders approving uniform listing and trading guidelines for narrow-based stock index warrants ("Generic Narrow-Based Index Warrant Approval Orders")).

<sup>25</sup> Securities Exchange Act Release Nos. 36165 (August 29, 1995) 60 FR 46653 (September 7, 1995) (NYSE); 36166 (August 29, 1995) 60 FR 46660 (September 7, 1995) (PCX); 36167 (August 29, 1995) 60 FR 46667 (September 7, 1995) (Phlx); 36168 (August 29, 1995) 60 FR 46637 (September 7, 1995) (Amex); and 36169 (August 29, 1995) 60 FR 36169 (CBOE) (September 7, 1995) (orders approving uniform listing and trading guidelines for index, currency and currency index warrants). See also, Securities Exchange Act Release No. 36296 (September 28, 1995) 60 FR 52234 (October 5, 1995) (order approving the National Association of Securities Dealers', Incorporated ("NASD") proposed to adopt uniform listing and trading guidelines for broad-based index warrants on the NASD's Automated Quotation Stock Market).

<sup>26</sup> Supra notes 23 and 24.

<sup>10</sup> 15 U.S.C. 78s(b)(1).

<sup>11</sup> See generally, Senate Comm. on Banking, Housing & Urban Affs., Report to accompany S. 249: Securities Acts Amendments of 1975, S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-38 (Comm. Print 1975), reprinted in (1975) U.S. Code Cong. & Ad. News 179, 200-15 (except on "Self-Regulation and Sec Oversight").

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> Section 19(b)(2)(B) of the Act, 15 U.S.C. 78s(b)(2)(B).

<sup>14</sup> See e.g., Securities Exchange Act Release No. 39011 (September 3, 1997), 62 FR 47841 (September 11, 1997) (order approving Chicago Board Options Exchange's, Incorporated ("CBOE") proposal to list and trade options based upon the Dow Jones Industrial Average) and Securities and Exchange Act Release No. 38693 (May 29, 1997), 62 FR 30914

options trading. In addition, the Commission has approved rules allowing for the listing of warrants overlying a single currency without a section 19(b) rule filing provided that the underlying currency has been approved for options trading.<sup>27</sup> The Commission also has approved rules allowing for the listing of warrants overlying a currency index without a section 19(b) rule filing provided the index previously has been approved by the Commission pursuant to a section 19(b) rule filing.

### *B. Reasons for Expanding the Scope of SRO Matters That Do Not Constitute Proposed Rule Changes*

Over the years, the Commission has approved numerous SRO trading rules, procedures and listing standards for various classes of new derivative securities products. The Commission preliminarily believes that when it has approved, pursuant to section 19(b) of the Act, an SRO's trading rules, procedures and listing standards for the product class that would include a new derivative securities product, the listing and trading of the new derivative securities product should therefore be reasonably and fairly implied by the SRO's existing trading rules, procedures and listing standards.<sup>28</sup>

SROs are facing increasing competition from overseas and over-the-counter ("OTC") derivatives markets.<sup>29</sup> The Commission believes that SROs should be able to bring new derivative securities products to market quickly to provide investors with tailored products that directly meet their evolving investment needs. Although the generic rules have helped to speed the process of reviewing new derivative securities product proposals, the Commission preliminarily believes that further changes are warranted. The Commission preliminarily believes that expanding the scope of SRO matters that do not constitute a proposed rule change to include the listing and trading of certain new derivative securities products will significantly speed the introduction of

new derivative securities products and enable SROs to maintain their competitive balance with the overseas and OTC derivative markets. The proposal should foster innovation and create a streamlined procedure for SROs to promptly list new products subject to appropriate trading rules, procedures, a surveillance program and listing standards.

At the same time, SROs have had over 20 years of experience with SEC review of new derivative securities product proposals. SROs that have sought approval from the Commission to list and trade such new derivative securities products should be familiar with the factors discussed in this release that the Commission believes should be considered when listing and trading such new derivative securities products. Thus, the Commission believes that there is less need for SEC review, notice and approval prior to an SRO trading a new derivative securities product pursuant to existing trading rules, procedures, a surveillance program and listing standards. Nonetheless, the Commission preliminarily believes that the proposed procedures discussed in this release will enable the Commission to continue to effectively protect investors and promote the public interest.

## **III. Discussion**

### *A. Definition of "New Derivative Securities Product"*

For the purposes of section 19(b) of the Act and Rule 19b-4 thereunder, the Commission proposes to define "new derivative securities product" as any type of option, warrant, hybrid securities product or any other security whose value is based upon the performance of an underlying instrument.

#### **1. New Derivative Securities Product Must Be a "Security" as Defined in Section 3(a)(10) of the Act**

The SROs have the authority to list and trade "securities" as defined in section 3(a)(10) of the Exchange Act.<sup>30</sup> The term "security" as defined in section 3(a)(10) of the Exchange Act, includes, among other instruments, "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to a foreign currency, or in general, any instrument commonly

known as a 'security'." <sup>31</sup> Because SROs currently do not have the authority to trade non-securities, the proposed amendment does not provide SROs with any new authority to list a new derivative product that is not a "security".<sup>32</sup>

## **2. Scope of Proposal**

As stated above, SROs have sought Commission approval to list and trade various new derivative securities products, including, among others, stock index options and warrants, unit investment trusts, foreign currency options and warrants, and indexed term notes. The Commission proposes to make the proposed amendment available to SROs seeking to list these classes of new derivative securities products and other classes, provided that such classes are subject to existing trading rules, procedures, a surveillance program and listing standards.

An SRO seeking to list a completely new class of derivative securities product without existing trading rules, procedures, a surveillance program and listing standards would still be required to submit a proposed rule change pursuant to section 19(b)(2) of the Act in order to adopt appropriate trading rules, procedures and listing standards for such class. These requirements are intended to ensure that there are

<sup>31</sup> *Id.*

<sup>32</sup> Furthermore, the proposal will only apply to securities SROs. It will not apply to entities that seek designation as contract markets for futures trading on an index or group of securities or to foreign boards of trade that apply to the Commodity Futures Trading Commission ("CFTC") for certification to sell their futures contracts to U.S. persons. Under the amendments to the CEA effected by the Futures Trading Act of 1982 (Pub. L. 97-444, 96 Stat. 2294), Section 2(a)(1)(B) of the CEA (7 U.S.C. 2(a)(1)(B)) prohibits any person from offering or selling a futures contract based on "any group or index of such securities or any interest therein based on the value thereof" except as permitted under Section 2(a)(1)(B)(ii) of the act. The CFTC is required to seek the views of the SEC regarding each such application concerning a stock index and the SEC may object to the designation on the ground that any of the statutory criteria have not been met. The proposal would not alter these procedures nor does the Commission believe that it is appropriate to do so. The Commission notes that it would have the ability to inspect the securities SROs in order to ensure that they comply with the terms of the proposed amendment when they do not submit proposed rule changes to list and trade new derivative securities products. Moreover, the Commission could take appropriate measures, including, but not limited to, ordering the SRO to remediate the deficiency or prohibiting opening transactions in or discontinuing the listing of new derivative securities products if the new derivative securities product did not comply with the terms of the proposed amendment. In contrast, for stock index futures contracts, neither inspection nor enforcement authority is available to the Commission. Consequently, the Commission believes that it is important for the Commission to continue to review the terms of any proposed stock index futures contract before it commences trading.

<sup>27</sup> *Supra* note 25.

<sup>28</sup> The Commission notes that currently with regard to equity issues, once an SRO has received approval for its trading rules, procedures and listing standards, the listing and trading of a specific new equity issue is not deemed a proposed rule change that requires a filing under Rule 19b-4 of the Act. Rather, an SRO can immediately list and trade a new equity issue so long as that equity issue satisfies the Commission approved trading rules, procedures and listing standards of the SRO.

<sup>29</sup> In order to further promote competition, the Commission proposes, in a separate release issued today (Securities Exchange Act Release No. 39884 (April 17, 1998)), to permit SROs to operate new trading systems subject to certain conditions, for a period not to exceed two years, without submitting a Rule 19b-4 filing.

<sup>30</sup> 15 U.S.C. 78(c)(1)(j).

adequate SRO rules to provide for fair and orderly trading for the class of securities. Thus, in order to rely on the proposed amendment, an SRO must have in place trading rules, procedures and listing standards for the specific class of new derivative securities product prior to the listing and trading of the class.<sup>33</sup> Procedures include, but are not limited to adequate procedures relating to sales practices (including suitability), margin and disclosure requirements. The SRO also must have a surveillance program adequate to monitor for abuses in the trading of the new derivative securities product, including trading in the underlying security or securities. Once an SRO has submitted, and the Commission has approved, a section 19(b)(2) proposal to establish an appropriate regulatory framework to support trading of a new class of new derivative securities product, the SRO would qualify under the proposed amendment for further new derivative securities products under the same class. For example, if an exchange without any options rules sought to trade options, it would first need to file a rule change, pursuant to Rule 19b-4, to adopt appropriate trading rules, procedures and listing standards that apply to options. In addition, the proposed amendment does not relieve an SRO from its obligation to submit a proposed rule change to amend its existing listing standards for particular classes of securities.

#### *B. Standards for All New Derivative Securities Products*

The proposal is premised upon the experience that the Commission has obtained through its review of new derivative securities product proposals by the SROs. Over the years, the Commission has identified the factors it believes new derivative securities

product proposals should meet in order to be consistent with the Act. In order to rely on the proposed amendment, an SRO should ensure that the new derivative securities product meets the criteria discussed below in the areas of: Design and maintenance of the instruments or index underlying the new derivative securities product; customer protection rules; surveillance of the component securities; and the potential market impact of the new derivative securities product.<sup>34</sup> Specifically, an SRO should have adequate information sharing agreements, clearance and settlement procedures, systems capacity and transaction reporting procedures for underlying securities.

#### *1. Information Sharing Agreements*

In designing a new derivative securities product, the SRO should ensure that it has adequate information sharing procedures to detect and deter potential trading abuses. It is essential that the SRO have the ability to obtain the information necessary to detect and deter market manipulation, illegal trading and other abuses involving the new derivative securities product. Specifically, there should be a comprehensive information sharing agreement ("ISA") in place between the SRO listing or trading a derivative product and the markets trading the securities underlying the new derivative securities product that covers trading in the new derivative securities product and its underlying securities.<sup>35</sup> Such agreements provide a necessary deterrent to manipulation because they facilitate the availability of information needed to fully investigate a manipulation if it were to occur.

For new derivative securities products based upon domestic securities, the SRO should ensure the markets upon which all of the U.S. component securities trade are members of the Intermarket Surveillance Group ("ISG").<sup>36</sup> The ISG was formed to

coordinate, among other things, effective surveillance and investigative information sharing arrangements in the stock and options markets.

For new derivative securities products based on securities from a foreign market, the SRO should have a comprehensive ISA with the market for the securities underlying the new derivative securities product. The SRO should ensure there are no blocking or secrecy laws in the foreign country that would prevent or interfere with the transfer of information under the comprehensive ISA. If securing a comprehensive ISA is not possible, the SRO should contact the Commission prior to listing the new derivative securities product. In such instances, the Commission may determine that it is appropriate instead to rely on a Memorandum of Understanding ("MOU") between the Commission and the foreign regulator.<sup>37</sup>

For a new derivative securities product overlying an instrument with component securities from several countries, the Commission recognizes that it may not be practical in all instances to secure comprehensive ISAs with all of the relevant foreign markets. Generally, foreign countries' securities or American depositary receipts that are not subject to a comprehensive ISA should not represent a significant percentage of the weight of such an underlying instrument.<sup>38</sup>

#### *2. Clearance and Settlement*

The calculation of the settlement value for the new derivative securities product should be clear, fixed and objective. In order to minimize market impact concerns, a new derivative securities product overlying an index of U.S. securities generally should be

<sup>33</sup> The Commission notes that several exchanges have adopted listing standard categories termed "other securities." These standards were adopted to allow the listing of securities that contain features borrowed from more than one category of currently listed securities, such as hybrid new derivative securities products that have characteristics of both common stock and debt securities. The Commission has clearly stated and reiterates its belief that such standards "are not intended to accommodate the listing of securities that raise significant new regulatory issues, and, therefore, would require a separate filing with the Commission pursuant to Rule 19b-4 under the Act." Securities Exchange Act Release No. 28217 (July 18, 1990) 55 FR 30056 (July 24, 1990). In other words, the "other securities" category is not intended to permit an SRO to list a new derivative securities product that does not fall under another listing category of the SRO. Accordingly, an SRO could not avoid the requirement of adopting appropriate listing standards in order to rely on the proposed amendment for a novel new derivative securities product by simply listing such product under the "other security" category.

<sup>34</sup> As discussed in Section IV. G. *Ensuring Proper Use Of The Proposed Amendment*, a failure to comply with the standards could compromise an SRO's reliance on the proposed amendment.

<sup>35</sup> The Commission believes that a comprehensive ISA should require that the parties provide each other, upon request, information about market trading, clearing activity and the identity of the ultimate purchasers and sellers of securities. See Securities Exchange Act Release No. 31529 (November 27, 1992) 57 FR 57248 (December 3, 1992).

<sup>36</sup> See ISG Agreement, dated July 14, 1983, amended January 29, 1990. The ISG members are: the Amex; the Boston Stock Exchange, Incorporated; the CBOE; the Chicago Stock Exchange, Inc.; the NASD; the NYSE; the PCX; and the Phlx. The major stock index futures exchanges joined the ISG as affiliate members in 1990.

<sup>37</sup> An MOU provides a framework for mutual assistance in investigatory and regulatory matters. Generally, the Commission has permitted an SRO to rely on an MOU in the absence of a comprehensive ISA only if the SRO receives an assurance from the Commission that such an MOU can be relied on for surveillance purposes and includes, at a minimum, the transaction, clearing and customer information necessary to conduct an investigation. See Securities Exchange Act Release No. 35184 (December 30, 1994) 60 FR 2616 (January 10, 1995) (order approving the listing and trading of warrants on the CBOE overlying the Nikkei Stock Index 300 where there was no comprehensive ISA between the CBOE and the underlying market, the Tokyo Stock Exchange but there was an MOU between the SEC and the Japanese Ministry of Finance). In addition, an SRO should endeavor to develop comprehensive ISAs with foreign exchanges that trade the underlying securities of an index even if the SRO receives prior Commission approval to rely on an MOU in place of a comprehensive ISA.

<sup>38</sup> If, however, a foreign security had more than 50% of its global trading volume in dollar value in U.S. markets, the Commission, in the past, has treated such security as a U.S. security.

settled based on opening prices of the component stocks. If opening price settlement is not utilized, the SRO should ensure that the settlement value reflects the last available closing prices prior to settlement for the underlying securities or some alternative objective settlement measurement. If the new derivative securities product is settled in foreign currency, the SRO should ensure that a recognized exchange rate is used to convert the settlement value into U.S. dollars. In addition, the SRO should ensure that adequate clearance procedures have been established for the new derivative securities product.

### 3. Systems Capacity

It is essential that the SRO and the applicable price reporting authority have adequate systems processing capacity to accommodate the listing and trading of a new derivative securities product. The SRO should, prior to listing a new derivative securities product, ensure that it has adequate systems processing capacity to accommodate the new listing and obtain a representation from the applicable price reporting authority that such price reporting authority also has adequate systems processing capacity.

### 4. Transaction Reporting of Underlying Securities

In order to prevent manipulation and ensure liquidity of securities underlying a new derivative securities product, underlying equity securities should be listed on a national securities exchange or traded through the facilities of a national securities association or otherwise subject to real-time public transaction reporting. For securities that are not subject to transaction reporting (e.g., municipal securities), there should be an objective means of capturing price information through disseminated quotations. For foreign securities underlying a new derivative securities product, an SRO should ensure that those securities satisfy and maintain all other criteria described in this release when relying on the proposed amendment.

### C. Index Based Products

In addition to the items discussed above, SROs should ensure that if a new derivative securities product is index based: The index is classified properly as broad-based or narrow-based; the index is constructed according to established criteria for initial inclusion of new component securities; the index is maintained so that it measures the same segment of the market as originally intended; the index value is disseminated frequently; component

securities that fail to meet the maintenance criteria are replaced according to established policies and procedures; and when the index is maintained by a broker-dealer, a functional separation exists between the broker-dealer's trading desk and research department.

#### 1. Designation of Index as Broad-Based or Narrow-Based

An SRO should first classify the underlying index as narrow-based (*i.e.*, containing securities from a specific industry sector or comprised of a small group of securities) or broad-based (*i.e.*, a larger group of securities that is representative of the entire market or a substantial portion of the entire market).<sup>39</sup> In order to make a determination that an index is broad-based, the SRO should identify how the index represents the overall stock market or a substantial portion thereof. The SRO should undertake an analysis of the basis for such a determination. A mere conclusion by the SRO that an index has been designated as broad-based is not determinative of the status of the index.

#### 2. Index Construction

The index underlying a new derivative securities product should be constructed according to established criteria for initial inclusion of new component securities. SROs seeking to rely on the proposed amendment should employ objective index construction standards that include a minimum number of component securities and a fixed and objective weighting methodology (e.g., capitalization weighted, price weighted or equal-dollar weighted).<sup>40</sup> In addition, SROs should use index construction standards that ensure that the underlying securities have sufficient liquidity so as to help reduce the potential for manipulation of the index's component securities. For example, the index construction criteria should include, among other things, a minimum price, available capitalization, average daily trading volume and value of each component security and set a maximum relative weight for the top component and the five largest components.

<sup>39</sup> Such a classification is essential because regulatory requirements such as position limits and margin levels are different for narrow-based and broad-based index options. See e.g., CBOE Rules 24.4, 24.4A and 24.11.

<sup>40</sup> See Generic Narrow-Based Index Option Approval Order, *supra* note 23 and Generic Narrow-Based Index Warrant Approval Orders, *supra* note 24.

#### 3. Maintenance Criteria

Maintenance criteria should be designed to ensure that an index that has derivative products overlying it continues to measure the same segment or sector of the market as originally intended, remains composed of liquid securities, and does not become dominated by one (or a few) component(s). As a result, an SRO seeking to rely on the proposed amendment should ensure the index meets reasonable maintenance standards.

#### 4. Dissemination of the Index Value

In most circumstances, the index value should be disseminated frequently and, if based on U.S. equities only, should reflect last-sale prices. If an index is comprised of both U.S. and foreign securities, prices for all securities that trade on markets that are open during U.S. trading hours should be disseminated, if practicable, at least every 15 seconds. Dissemination of an index value based in whole or in part on closing prices of component securities should occur only for those component securities where the underlying markets are closed during U.S. trading hours (the disseminated index value may still be adjusted for currency fluctuations) or the underlying component value itself is not calculated real-time (e.g., indices of open-end mutual funds that report net asset value at the close of trading).<sup>41</sup> Certain indices may use quotes (e.g., a bond index) if last sale prices are unavailable and the quotes are reliable and spread across several dealers.

#### 5. Component Changes

Component securities that fail to meet the index maintenance standards should be replaced within the index according to established policies and procedures for reviewing and replacing such component securities. Automatic rebalancing of index components also should occur according to established policies and procedures (e.g., annually, semi-annually or quarterly). Notice of component changes should be disseminated to news vendors and the public. SROs should ensure that components are replaced promptly in the event of specified circumstances such as corporate mergers or spin-offs.

#### 6. Functional Separation Letter

When the index is maintained by a broker-dealer or an affiliate of a broker-dealer, the SRO should assure, prior to the listing of a new derivative securities product, that there will be a functional

<sup>41</sup> Securities Exchange Act Release No. 39244 (October 15, 1997) 62 FR 55289 (October 23, 1997).

separation between the trading desk of the broker-dealer and the research persons responsible for maintaining the index through a fire wall. A fire wall is a mechanism by which employees responsible for constructing and maintaining the index are separated from employees involved in the sale and trading of securities. In accordance with the broker-dealer's fire wall mechanism, the persons responsible for maintaining an index should be subject to certain procedures limiting the dissemination of index information within the broker-dealer and particularly should be prohibited from relaying any information concerning a potential change to the components of the index to anyone not responsible for maintaining the index, including employees of the sales and trading department.

#### *D. Compliance With Other Federal Securities Laws*

The Commission notes that the proposed amendment does not relieve SROs from any other obligation under the federal securities laws, or rules or regulations thereunder, except the requirement of filing a proposed rule change pursuant to section 19(b) of the Act and Rule 19b-4 thereunder. For example, Form S-20<sup>42</sup> under the Securities Act of 1933, as amended ("Securities Act")<sup>43</sup> and Rule 9b-1<sup>44</sup> under the Exchange Act establish a disclosure framework specifically tailored to the informational needs of investors in "standardized options"<sup>45</sup> that are traded on an "options market"<sup>46</sup>. Under Rule 9b-1, broker-dealers must provide an updated copy of the options disclosure document ("ODD")<sup>47</sup> to each customer at or prior to the approval of the customer's account for trading in standardized options.<sup>48</sup> Accordingly, when trading a

new standardized option, an SRO must determine if it should change the ODD to reflect specific characteristics and risks associated with the new derivative securities product not currently set forth in the ODD and submit such changes to the Commission. In addition, a particular new derivative securities product may need to be designated as a standardized option under Rule 9b-1 in order to utilize the ODD.<sup>49</sup> If the proposing SRO and the issuer of the new derivative securities product determine that such steps are necessary, they are required to submit proposals to the Commission, under Rule 9b-1, prior to listing the new derivative securities product.

The Commission preliminarily notes that the proposed amendment to Rule 19b-4 may still be available if an SRO determines that the above steps are necessary. So long as all conditions to the proposed amendment are met, including the existence of appropriate current listing standards for the new product, the SRO may immediately list the new derivative securities product without a Section 19(b) rule filing after the Commission designates the particular new product as a "standardized option" and approves the Rule 9b-1 filing of amendments to the ODD.

In addition to Form S-20 and Rule 9b-1, the Commission notes that other federal securities laws must be complied with even when an SRO relies on the proposed amendment to Rule 19b-4. For example, issuers of new derivative securities products must continue to comply with, among other things, the registration requirements of the Securities Act and in addition, if a product is an investment company<sup>50</sup> regulated under the Investment Company Act of 1940, as amended, ("ICA")<sup>51</sup> the product must comply with the ICA.

#### *E. Existing Trading Rules, Procedures, Surveillance Programs and Listing Standards*

An SRO wishing to list a new derivatives securities product should have in place trading rules, procedures, a surveillance program and listing standards that pertain to the class of securities covering the new product. For

example, the Amex, CBOE, NYSE,<sup>52</sup> PCX, and Phlx are the only SROs that currently have in place trading rules, position limits, margin requirements and internal surveillance programs that pertain to the listing and trading of narrow-based stock index options.<sup>53</sup> Should another exchange desire to trade narrow-based index options, it would first have to submit a proposed rule change to the Commission adding relevant trading rules, procedures and listing standards to its rules. Procedures include, but are not limited to adequate procedures relating to sales practices (including suitability), margin and disclosure requirements. Otherwise, the SRO would be in violation of sections 6(b) and 19(b) of the Act in order to assure fair and orderly trading markets. The SRO also must have a surveillance program adequate to monitor for abuses in the trading of the new derivative securities product, including trading in the underlying security or securities.

SROs that have the appropriate regulatory framework in place for a specific class of new derivative securities product could immediately list such class of new derivative securities product, provided the particular SRO satisfies the conditions for the proposed amendment. If an SRO sought to alter position limits, margin requirements, or any other rules or procedures for a new derivative securities product class, however, it would be required to submit a section 19(b)(2) rule filing for Commission review. The SRO could apply such proposed rule changes to a new product only after the Commission has reviewed and approved the proposal pursuant to section 19(b)(2). For example, if an options exchange wanted to list immediately a new narrow-based index option it could do so under its existing applicable rules. In particular, the SRO could immediately list the new narrow-based index option and impose its existing position limits and margin requirements.

If the SRO wanted to impose different position limits or margin requirements, or alter other existing trading rules or procedures for the new derivative securities product class, it would still be required to submit to the Commission a rule filing proposing such changes to its existing rules pursuant to section 19(b)(2) of the Act. This framework would not prevent an SRO from using

<sup>42</sup> 17 CFR 239.20. Form S-20 is used to register classes of options under the Securities Act.

<sup>43</sup> 15 U.S.C. 77a et seq.

<sup>44</sup> 17 CFR 240.9b-1.

<sup>45</sup> Standardized options" are options contracts trading on a national securities exchange, an automated quotation system of a registered securities association or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices or such other securities as the Commission may, by order, designate. 17 CFR 240.9b-1(a)(4).

<sup>46</sup> Options market" means a national securities exchange, an automated quotation system of a registered securities association or a foreign securities exchange on which standardized options are traded. 17 CFR 240.9b-1(a)(1).

<sup>47</sup> The ODD identifies the issuer and describes the uses, mechanics and risks of options trading and other matters in language that can be easily understood by the general investing public.

<sup>48</sup> The ODD may be used as a substitute for the traditional prospectus.

<sup>49</sup> See Securities Exchange Act Release No. 31920 (February 24, 1993) 58 FR 12280 (March 3, 1993) (order approving CBOE proposal to list and trade FLEX Options based on the S & P's 500 and 100 Stock Indices).

<sup>50</sup> See e.g., Investment Company Act Release No. 21802 (March 5, 1996) (exemptive order under the ICA permitting the trading of Countrybasket Index Funds on the NYSE).

<sup>51</sup> 15 U.S.C. 80a et seq.

<sup>52</sup> Although the NYSE transferred its options business to the CBOE, supra note 23, the NYSE still has listing standards for narrow-based index options in its rules.

<sup>53</sup> See e.g., Amex Rules 900c through 980C; CBOE Rules 24.1 through 24.8; and PCX Rules 7.1 through 7.18.

the proposed amendment to immediately list a new derivative securities product under its existing rules, and then impose different position limits, margin requirements, or any other trading rule for the new product once the Commission has approved the Section 19(b)(2) rule filing proposing such rule changes.<sup>54</sup>

#### *F. Form of Notification to the SEC of New Derivative Securities Product Listing Pursuant to the Proposed Amendment*

In order for the Commission to maintain an accurate record of all new derivative securities products traded on the SROs, it is proposing that an SRO file a new form, proposed Form 19b-4(e), to notify the Commission when an SRO begins to trade a new derivative securities product that is not required to be submitted as a proposed rule change to the Commission for approval. Proposed Form 19b-4(e) should be submitted within five business days after an SRO begins trading a new derivative securities product that is not the subject of a proposed rule change.

#### *G. Ensuring Proper Use of the Proposed Amendment*

The Commission contemplates that its Office of Compliance Inspections and Examinations ("OCIE") will review SRO compliance with the proposed amendment through its routine inspection process of the SROs. In order for OCIE to determine whether an SRO has properly availed itself of the proposed amendment, it is necessary that the SRO maintain, on-site, relevant records and information pertaining to each new derivative securities product for which the SRO relied on the proposed amendment. Such records should be maintained for a period of not less than five years, the first two years in an easily accessible place, according

to the recordkeeping requirements set forth in Rule 17a-1 under the Act.<sup>55</sup>

Such records available for OCIE review would include, among other things, a copy of proposed Form 19b-4(e) under the Act and whether the factual and numerical information regarding the new derivative securities product's characteristics meet the conditions of the proposed amendment. The SRO should be able to provide the listing standard under which the new derivative securities product falls as well as, but not limited to, such other things as the details of its surveillance program, records of adequate information sharing procedures and index construction and maintenance standards. In short, the Commission believes that when an SRO relies on the proposed amendment, such SRO should ensure that its regulatory framework adequately supports the listing and trading of any new derivative securities product. Failure to comply with this requirement would mean that the SRO could be in violation of the Act. If so, appropriate measures would be taken, including, but not limited to, ordering the SRO to remediate the deficiency or prohibiting opening transactions in or discontinuing the listing of new derivative securities products.<sup>56</sup>

#### **IV. Technical Changes**

Because the Commission proposes that a new paragraph (e) be added to Rule 19b-4 under the Act, Form 19b-4 under the Act<sup>57</sup> is amended by revising the phrase "subparagraph (e) of Rule 19b-4" to read "subparagraph (f) of Rule 19b-4" and the phrase "subparagraph (e) of Securities Exchange Act Rule 19b-4" to read "subparagraph (f) of Securities Exchange Act Rule 19b-4" in Exhibit 1, III. (B); and in Exhibit 1, IV. revise the first sentence to read "Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Exchange Act."

#### **V. Conclusion**

For the reasons discussed above, the Commission preliminarily believes that an amendment to Rule 19b-4 under the Act that deems the listing and trading of new derivative securities products pursuant to existing SRO trading rules, procedures, surveillance programs and listing standards, to not be a proposed

rule change will reduce significantly the SROs' regulatory burden and help SROs maintain their competitive balance with the overseas and OTC derivatives markets. The proposed amendment to Rule 19b-4 will provide guidelines for SROs seeking to rely on it but removes the need for SEC review, notice and approval prior to an SRO trading a new derivative securities product pursuant to existing SRO trading rules, procedures, surveillance programs and listing standards.<sup>58</sup>

The Commission preliminarily believes that the proposed amendment offers potential benefits for investors. If adopted, the proposed amendment will facilitate the listing and trading of new derivative securities products by permitting SROs to bring such products to market quickly to provide investors with tailored products that directly meet their evolving investment needs. The Commission does not anticipate that the proposed amendment will result in any costs for U.S. investors or others. The Commission preliminarily believes that the proposed amendment would reduce the cost of offering new derivative securities products to investors because it will foster innovation and create a streamlined process for SROs to list and trade such new derivative securities products subject to existing trading rules, procedures, surveillance programs and listing standards. Thus, the Commission has considered the proposed amendment's impact on efficiency, competition and capital formation and preliminarily believes that it would promote these three objectives.<sup>59</sup> Finally, the Commission believes that the SROs will spend significantly less time filling out the form to be used under the proposed amendment than they do now when submitting a complete proposed rule change for Commission review, notice and approval pursuant to Rule 19b-4 under the Act.

<sup>54</sup> The Commission does not anticipate that every proposed change in an SRO's existing trading rules to accommodate a new derivatives securities product will require a Section 19(b)(2) rule filing. An SRO will not be required to submit a rule filing for a stated policy, practice or interpretation of the SRO that is reasonably or fairly implied by an existing rule of the SRO or is concerned solely with the administration of the SRO and is not a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of an existing rule of the SRO. 17 CFR 240.19b-4(c), *supra* note 7. For example, if an SRO has rules that merely delineate each new derivative securities product covered by a particular existing trading rule, the SRO need not submit a rule filing pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder merely because it is adding a new derivative securities product to the list. See *e.g.*, CBOE Rule 24.9(a)(3) and (4).

<sup>55</sup> 17 CFR 240.17a-1. SROs may also destroy or otherwise dispose of such records at the end of five years according to Rule 17a-6 under the Act, 17 CFR 240.17a-6.

<sup>56</sup> See section 19(h) of the Act, 15 U.S.C. 78s(h).

<sup>57</sup> 17 CFR 249.819.

<sup>58</sup> The Commission anticipates that the proposed amendment will eliminate approximately 45 SRO filings each year pursuant to Rule 19b-4 and Form 19b-4. In addition, the Commission believes that the proposed amendment reduces the recordkeeping and reporting requirements, pursuant to Rule 19b-4 and Form 19b-4, on the SROs by permitting them to submit a one page summary form after they list a new derivative securities product instead of filing a complete proposed rule change for Commission review prior to listing such new derivative securities product.

<sup>59</sup> Section 3(f) of the Act, 15 U.S.C. 78c(f), requires the Commission, when it is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.



## VI. Request for Public Comments

The Commission seeks comments on adopting proposed Rule 19b-4(e) and Form 19b-4(e) under the Act. Commentators are asked to consider whether the proposed amendment provides appropriate review of the listing and trading of new derivative securities products subject to existing trading rules, procedures, surveillance programs and listing standards. Specifically, comments should address whether more or less information is needed on Form 19b-4(e) in order to enable the Commission to comply with its statutory obligations to help remove impediments to a free and open securities market, protect investors and promote the public interest. For example, should Form 19b-4(e) require the SRO to cite its relevant standards under which it has listed a new derivative securities product? Commentators also may wish to discuss whether there are any legal or policy reasons why the Commission should consider a different approach in regulating new derivative securities products. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed amendment on the economy on an annual basis. If possible, commentators should provide empirical data to support their views. Finally, commentators should consider the proposed rule amendment's effect on competition, efficiency and capital formation. Comments should be submitted by May 29, 1998.

## VII. Costs and Benefits of the Proposed Amendment and its Effects on Competition, Efficiency and Capital Formation

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed amendment, commentators are requested to provide analysis and data, if possible, relating to costs and benefits associated with the proposal herein. The Commission preliminarily believes that the proposed amendment will reduce SRO compliance burdens under Rule 19b-4.<sup>60</sup> The proposal would reduce

significantly the SROs' regulatory burden and help SROs maintain their competitive balance with the overseas and OTC derivative markets.<sup>61</sup> Moreover, the Commission believes that the proposed amendment will foster innovation and create a streamlined procedure for SROs to promptly list new derivative securities products subject to appropriate listing standards.

The individual hour burden for each respondent to the collection of information requirements of proposed Rule 19b-4(e) and Form 19b-4(e) under the Act is estimated to be two hours per proposed Form 19b-4(e). The annual aggregate burden for all respondents to the recordkeeping collection of information requirements of proposed Rule 19b-4(e) and Form 19b-4(e) under the Act is estimated to be 90 hours. This burden is computed by estimating that an SRO will utilize 1 hour of in-house legal processing time to prepare the substantive information for proposed Form 19b-4(e) and 1 hour of clerical time to process proposed Form 19b-4(e) for filing. The Commission estimates that an SRO will incur a cost of \$88 for each proposed Form 19b-4(e) that it submits.<sup>62</sup> Thus, the total cost per year to all SROs to comply with proposed Rule 19b-4(e) and Form 19b-4(e) is estimated to be \$7,920 (90 hours at \$88

respectively. The cost per hour and per filing is derived from information supplied by the SROs. We have valued related overhead at 35% of the value of legal and clerical work combined. See GSA *Guide to Estimating Reporting Costs* (1973).

The annual aggregate burden was derived as follows: 30 routine filings at 25 hours legal review time per filing equals 750 hours; 15 significant filings at 100 hours legal review time per filing equals 1,500 hours; and 45 total filings at 1 hour of clerical work per filing equals 45 hours. The total of the three sums equals 2,295 hours.

The annual aggregate cost was derived as follows: 2,250 hours of in-house legal work at \$50 per hour equals \$112,500; 45 hours of clerical work at \$15 per hour equals \$675; and overhead equals \$39,611. The total of the three sums equals \$152,786.

A routine filing is one that takes the Commission approximately 90 days to approve and a significant filing takes more time. See *infra* note 61.

<sup>61</sup> The Commission estimates that under current procedures, a proposed rule filing for a new derivative securities product takes 90 days, on average, from the date of the original submission, to be approved. In contrast, the proposed amendment permits SROs to immediately list and trade a new derivative securities product so long as such product is in compliance with proposed Rule 19b-4(e) under the Act.

<sup>62</sup> The Commission estimates that the \$88 cost will be broken down as follows: 1 hour in-house professional work at \$50 per hour; 1 hour of clerical work at \$15 per hour; and overhead (telephone, copying and postage) at \$23 per Proposed Form 19b-4(e).

We have valued related overhead at 35% of the value of legal and clerical work combined. The cost per hour and per Form 19b-4(e) is derived from the information supplied by the SROs used to compute the SROs' burden under Form 19b-4, see note 60, *supra*.

per hour). When the annual aggregate SRO burden of preparing proposed Form 19b-4(e) (positive 90 hours) is added to the reduction in SRO burden hours under Form 19b-4 (negative 2,295 hours), the Commission estimates that the SROs would receive an aggregate net savings of 2,205 burden hours per year.

In addition, section 23(a)(2)<sup>63</sup> of the Act requires that the Commission, when promulgating rules under the Exchange Act, to consider the impact any rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in the public interest. The Commission has considered the proposed amendment in light of the standards cited in section 23(a)(2) of the Act and believes that it would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. Indeed, the Commission believes that the proposed amendment will reduce compliance cost and will enable SROs to compete more effectively with overseas and OTC derivatives markets. The Commission preliminarily believes that SROs should be able to bring new derivative securities products to market quickly to provide investors with tailored products that directly meet their evolving investment needs.<sup>64</sup> SROs have had over 20 years of experience with SEC review of new derivative securities product proposals. SROs that have sought approval from the Commission to list and trade such new derivative securities products should be familiar with the factors discussed in this release that the Commission believes should be considered when listing and trading such new derivative securities products. Thus, the Commission preliminarily believes that there is less need for SEC review, notice and approval prior to an SRO trading a particular new derivative securities product pursuant to existing SRO trading rules, procedures, a surveillance program and listing standards. The Commission preliminarily believes that the proposed procedures discussed in this release will enable the Commission to continue to effectively protect investors and promote the public interest. Nonetheless, the Commission solicits comments on the costs, benefits and competitive effects of the proposed rule amendment, in general, and the potential competitive effects across

<sup>63</sup> See 15 U.S.C. 78w(a)(2).

<sup>64</sup> The Commission also believes that the proposed amendment will benefit broker-dealers. See VII. *Summary of Regulatory Flexibility Act Analysis*, *infra*.

<sup>60</sup> See *supra* note 58. As previously stated, the Commission believes that the proposed amendment reduces the recordkeeping and reporting requirements, pursuant to Rule 19b-4 and Form 19b-4, on the SROs by eliminating the requirement of filing a complete proposed rule change for Commission review prior to trading a new derivative securities product. The Commission estimates that the annual aggregate burden and annual aggregate cost for all respondents under Form 19b-4 would be reduced by 2,295 hours and \$152,786,



markets, in particular. Specifically, the Commission requests commentators to address whether the proposed amendment would generate the anticipated benefits or impose any costs on U.S. investors or others.

### VIII. Summary of Regulatory Flexibility Act Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. 605(b) regarding the proposed amendment to Rule 19b-4 and Form 19b-4(e) under the Exchange Act. The following summarizes the IRFA.

The IRFA sets forth the statutory authority for the proposed amendment to Rule 19b-4. The IRFA also discusses the effect of the proposed amendment on broker-dealers that are small entities as defined in Rule 0-10 under the Exchange Act.<sup>65</sup> A broker-dealer that has total capital of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, or, if not required to prepare such statements, a broker-dealer that had total capital of less than \$500,000 on the last business day of the preceding fiscal year is deemed to be a small entity for purposes of the IRFA. The IRFA states that the proposed amendment would enable broker-dealers that are small entities (such as certain options market makers and options specialists) to trade new derivative securities products pursuant to existing trading rules, procedures, surveillance programs and listing standards approximately 90 days earlier, on average, because the proposed amendment will permit SROs to immediately list these new derivative securities product without prior Commission approval. As a result, broker-dealers will have additional days to earn income through trading such new derivative securities products. As of December 31, 1996, the Commission estimated that there were over 900 options market makers and specialists that may be considered small entities.<sup>66</sup>

The IRFA states that the proposed amendment would not impose any new reporting, recordkeeping or compliance requirements on broker-dealer small entities. Any new reporting, recordkeeping or compliance burdens rest with the SROs, not broker-dealer small entities.

The IRFA discusses the various alternatives considered by the

Commission in connection with the proposed amendment that might minimize the effect on small entities, including: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule amendment, or any part thereof, for small entities. The Commission believes that different compliance or reporting requirements for small entities are not necessary because the proposed rule amendment does not establish any new reporting, recordkeeping or compliance requirements for small entities. In addition, the Commission has concluded that it is not feasible to further clarify, consolidate or simplify the proposed rule amendment for small entities. The Commission also believes that it would be inconsistent with the purposes of the Act to use performance standards to specify different requirements for small entities or to exempt broker-dealer small entities from being able to trade new derivative securities products that are covered by the proposed rule amendments.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rule amendment. A copy of the IRFA may be obtained by contacting Marianne H. Duffy, Special Counsel, (202) 942-4163 at Office of Market Supervision, Division of Market Regulation, SEC, Mail Stop 10-1, 450 Fifth Street, NW., Washington, DC 20549.

### IX. Paperwork Reduction Act

Certain provisions of the proposed amendment to Rule 19b-4 contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995<sup>67</sup> through the use of proposed Form 19b-4(e) under the Act. The Commission has submitted the collection to the Office of Management and Budget ("OMB") in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. Persons should note that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The title for the collection of

information is: "Form 19b-4(e) Under the Securities Exchange Act of 1934."

#### A. Summary of Collection of Information Under Proposed Rule 19b-4(e) and Form 19b-4(e)

The collection of information would require SROs to prepare a one-page summary sheet of nine questions that requests factual information regarding the characteristics of the new derivative securities product and the underlying securities. Such questions do not require any analysis or exhibits.

#### B. Proposed Use of the Information

Currently, in order to list and trade a new derivative securities product, an SRO must submit a proposed rule change to the Commission pursuant to section 19(b) of the Exchange Act and Rule 19b-4 thereunder. Paragraph (c) of Rule 19b-4 provides that certain stated policies, practices and interpretations of SROs do not constitute proposed rule changes. Specifically, a "stated policy, practice or interpretation" of an SRO shall be deemed to be a proposed rule change unless it is reasonably and fairly implied by an existing rule of the SRO. The Commission proposes to not deem the listing and trading of new derivative securities products as proposed rule changes pursuant to Rule 19b-4(c)(1) because, if the Commission has approved, pursuant to section 19(b) of the Act, such SRO's trading rules and procedures and listing standards for the product class that would include the new derivative securities product, the listing and trading of the new derivative securities product is reasonably and fairly implied by the existing trading rules and procedures and listing standards.

Under current procedures, a proposed rule filing for a new derivative securities product takes approximately 90 days from the date of the original submission to be ordered.<sup>68</sup> In contrast, the proposed amendment permits SROs to immediately list and trade a new derivative securities product so long as such new derivative securities product is in compliance with proposed Rule 19b-4(e) under the Act. However, in order for the Commission to maintain an accurate record of all new derivative securities products traded on the SROs and to determine whether an SRO has properly relied on the proposed amendment, it is necessary that the SRO file proposed Form 19b-4(e) with the Commission when such SRO begins trading a new derivative securities product pursuant to the proposed amendment. In addition, an SRO must

<sup>65</sup> 17 CFR 240.0-10(c).

<sup>66</sup> The Commission bases its estimate on the information provided in Form X-17A-5—Financial and Operational Combined Uniform Single Reports pursuant to section 17 of the Act and Rule 17a-5 thereunder.

<sup>67</sup> 44 U.S.C. 3501 et seq.

<sup>68</sup> See supra note 61.

maintain, on-site, a copy of proposed Form 19b-4(e). The Commission contemplates that it will ensure SRO compliance with the proposed amendment through its routine inspection process of the SROs.

#### C. Respondents

The proposed amendment may be used by any SRO. Currently, there are ten such SROs for which it is estimated that the proposed amendment would be used, in the aggregate, approximately 45 times a year.

#### D. Total Annual Reporting and Recordkeeping Burden

The individual burden for each respondent to the collection of information requirements of proposed Rule 19b-4(e) and Form 19b-4(e) under the Act is estimated to be two hours per proposed Form 19b-4(e). The annual aggregate burden for all respondents to the collection of information requirements of proposed Rule 19b-4(e) and Form 19b-4(e) under the Act is estimated to be 90 hours. This burden is computed by estimating that an SRO will utilize 1 hour of in-house legal processing time to prepare the substantive information for proposed Form 19b-4(e) and 1 hour of clerical time to process proposed Form 19b-4(e) for filing. The Commission also estimates that an SRO will incur an additional cost of \$23 for overhead, including telephone, copying and postage, for each proposed Form 19b-4(e) that it submits.<sup>69</sup> Thus, the total operation and maintenance cost per year, in addition to the burden hours, to all SROs to comply with proposed Rule 19b-4(e) and Form 19b-4(e) is estimated to be \$7,920 (90 hours at \$88 per hour).

In addition, as previously stated, because SROs will no longer be required to file a lengthier Form 19b-4, the Commission estimates that the annual aggregate costs and annual aggregate burden for all respondents under Form 19b-4 would be reduced by \$152,786 and 2,295 hours, respectively.<sup>70</sup> As previously stated, when the annual aggregate SRO burden of preparing proposed Form 19b-4(e) is added to the reduction in SRO burden hours under Form 19b-4, the Commission estimates that the SROs would receive an aggregate net savings of 2,205 burden hours per year.

#### E. Retention Period for Recordkeeping Requirements

The SROs would be required to retain records of the collection of information

for a period of not less than five years, the first two years in an easily accessible place, according to the current recordkeeping requirements set forth in Rule 17a-1 under the Act.<sup>71</sup>

#### F. Collection of Information Is Mandatory

Any collection of information pursuant to proposed Rule 19b-4(e) and Form 19b-4(e) under the Act would be mandatory as a means for the Commission to maintain accurate records of new derivative securities products that are traded.

#### G. Responses to Collection of Information Will Not Be Kept Confidential

Any collection of information pursuant to proposed Rule 19b-4(e) and Form 19b-4(e) under the Act would not be confidential and would be publicly available from the Commission upon request.

#### H. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- (i) Evaluate whether the proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility;
- (ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;
- (iii) Enhance the quality, utility and clarity of the information to be collected;
- (iv) and minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (i) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 3208, New Executive Office Building, Washington, D.C. 20503; and (ii) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549 with reference to File No. S7-13-98. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if

OMB receives it within 30 days of publication.

#### X. Statutory Basis

The amendment to Rule 19b-4(e) under the Exchange Act is being proposed pursuant to 15 U.S.C. 78a *et seq.*, particularly sections 3(a)(27), 3(b), 19(b), 23(a) and 36(a) of the Act, unless otherwise noted.

#### Text of the Proposed Rule

##### List of Subjects in 17 CFR Parts 240 and 249

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

#### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for part 240 is revised to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.19b-4 is amended by redesignating paragraphs (e), (f), (g), and (h) as paragraphs (f), (g), (h) and (i) and adding new paragraph (e) to read as follows:

##### § 240.19b-4 Filings with respect to proposed rule changes by self-regulatory organizations.

\* \* \* \* \*

(e) For the purposes of this paragraph, *new derivative securities product* means any type of option, warrant, hybrid securities product or any other security whose value is based upon the performance of an underlying instrument.

(1) The listing and trading of a new derivative securities product by a self-regulatory organization shall not be deemed a proposed rule change, pursuant to paragraph (c)(1) of this section, if the Commission has approved, pursuant to Section 19(b) of the Act (15 U.S.C. 78s(b)), the self-regulatory organization's trading rules, procedures and listing standards for the product class that would include the new derivative securities product and the self-regulatory organization has a surveillance program for the product class.

(2) Recordkeeping and reporting:

<sup>69</sup> Supra note 62.

<sup>70</sup> Supra note 60.

<sup>71</sup> SROs may also destroy or otherwise dispose of such records at the end of five years according to Rule 17a-6 under the Act, supra note 55.

(i) Self-regulatory organizations shall retain at their principal place of business a file, available to Commission staff for inspection, of all relevant records and information pertaining to each new derivative securities product traded pursuant to this paragraph (e) for a period of not less than five years, the first two years in an easily accessible place, as prescribed in § 240.17a-1.

(ii) When relying on this paragraph (e), a self-regulatory organization shall submit Form 19b-4(e) (17 CFR 249.820) to the Commission within five business days after commencement of trading a new derivative securities product.

\* \* \* \* \*

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted;

\* \* \* \* \*

4. Form 19b-4 (referenced in § 249.819) is amended as by revising the phrase “subparagraph (e) of Rule 19b-4” to read “subparagraph (f) of Rule 19b-4” and the phrase “subparagraph (e) of Securities Exchange Act Rule 19b-4” to read “subparagraph (f) of Securities Exchange Act Rule 19b-4” in Exhibit 1, III. (B); and in Exhibit 1, IV. revise, the first sentence to read “Interested persons are invited to submit written data, views and arguments concerning the foregoing,

including whether the proposed rule change is consistent with the Exchange Act.”

5. Section 249.820 and Form 19b-4(e) are added to read as follows:

§ 249.820 Form 19b-4(e) for the listing and trading of new derivative securities products by self-regulatory organizations that are not deemed proposed rule changes pursuant to Rule 19b-4(e) (§ 240.19b-4(e)).

This form shall be used by all self-regulatory organizations, as defined in Section 3(a)(26) of the Act, to notify the Commission of a self-regulatory organization's listing and trading of a new derivative securities product that is not deemed a proposed rule change, pursuant to Rule 19b-4(e) under the Act (17 CFR 240.19b-4(e)).

BILLING CODE 8010-01-P

[Note: Form 19b-4(e) will not appear in the Code of Federal Regulations.]

<p>OMB Approval Number 3235- Expires: Estimated average burden hours per response: 2.00</p> <p><b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b></p> <p><b>FORM 19b-4(e)</b></p> <p><b>Information Required of a Self-Regulatory Organization Listing and Trading a New Derivative Securities Product Pursuant to Rule 19b-4(e) Under the Securities Exchange Act of 1934</b></p>	
<b>READ ALL INSTRUCTIONS PRIOR TO COMPLETING FORM</b>	
<b>Part I</b>	<b>Initial Listing Report</b>
1.	Name of Self-Regulatory Organization Listing New Derivative Securities Product:
2.	Type of Issuer of New Derivative Securities Product ( <u>e.g.</u> , clearinghouse, broker-dealer, corporation, etc.):
3.	Class of New Derivative Securities Product:
4.	Name of Underlying Instrument:
5.	If Underlying Instrument is an Index, State Whether it is Broad-Based or Narrow-Based:
6.	Ticker Symbol(s) of New Derivative Securities Product:
7.	Market or Markets Upon Which Securities Comprising Underlying Instrument Trades:
8.	Settlement Methodology of New Derivative Securities Product:
9.	Position Limits of New Derivative Securities Product (if applicable):

<b>Part II</b>	<b>Execution</b>
<p>The undersigned represents that the governing body of the above-referenced Self-Regulatory Organization has duly approved, or has duly delegated its approval to the undersigned for, the listing and trading of the above-referenced new derivative securities product according to its relevant trading rules, procedures, surveillance programs and listing standards.</p>	
<p>Name of Official Responsible for Form:</p>	
<p>Title:</p>	
<p>Telephone Number:</p>	
<p>Manual Signature of Official Responsible for Form:</p>	
<p>Date:</p>	

#### Instructions for Completing Form 19b-4(e)

- I. Terms. Unless the context clearly indicates otherwise, terms used in this Form have the meaning ascribed to them in the Securities Exchange Act of 1934, as amended, and Rule 19b-4 thereunder.
- II. Who Must File; When to File. Rule 19b-4(e) requires every self-regulatory organization (SRO) seeking to rely on Rule 19b-4(e) to file Form 19b-4(e) with the Securities and Exchange Commission (Commission or SEC) at least 5 business days after commencement of trading a new derivative securities product that is not deemed to be a proposed rule change. Each time an SRO files Form 19b-4(e), the execution page must be completed.
- III. Number of Copies; How and Where to File. File the original and nine copies of each Form 19b-4(e) with the Division of Market Regulation, SEC, 450 Fifth Street, N.W., Washington, D.C. 20549. The SRO must keep an exact copy of the filing for its records. All copies must be legible. The filing date of any Form 19b-4(e) is the date of its actual receipt by the SEC, provided that the filing complies with applicable requirements.
- IV. Format of Filing. An SRO may use the printed Form 19b-4(e) or a reproduction of it.

- V. Paperwork Reduction Act Disclosure. Form 19b-4(e) requires an SRO filing the Form to provide the Commission with certain information concerning the nature of the new derivative securities product it intends to list and/or trade.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(a)(26), 3(a)(27), 3(a)(28), 3(b), 19(b), 23(a) and 36(a) of the Securities Exchange Act of 1934 authorize the Commission to collect information on Form 19b-4(e) from SROs. See 15 U.S.C. §§78c(a)(26), 78c(a)(27), 78c(a)(28), 78c(b), 78s(b), 78w(a), 78mm(a).

Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form 19b-4(e) and any suggestions for reducing this burden.

The principal purpose of Form 19b-4(e) is to enable the Commission to maintain an accurate record of the listing and trading of all new derivative securities products on the SROs not deemed to be proposed rule changes pursuant to Rule 19b-4(e).

It is estimated SROs will spend approximately 2 hours completing each Form 19b-4(e).

It is mandatory that an SRO file Form 19b-4(e) with the Commission at least 5 business days after commencement of trading a new derivative securities product that is not deemed to be a proposed rule change.

No assurance of confidentiality is given by the Commission with respect to the responses made in the Form. The public has access to the information contained in the Form.

This collection of information has been reviewed by the Office of Management and Budget (OMB) in accordance with the clearance requirements of 44 U.S.C. 3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records are set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

By the Commission.

Dated: April 17, 1998.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-10946 Filed 4-28-98; 8:45 am]

BILLING CODE 8010-01-C