

## SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-40754; File No. SR-Amex-98-25)

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the American Stock Exchange, Inc. Relating to Listing and Trading Stock Upside Note Securities on the Lehman Brothers European Stock Basket

December 7, 1998.

#### I. Introduction

On July 1, 1998, the American Stock Exchange, Inc. ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to list and trade Stock Upside Note Securities on the Lehman Brothers European Stock Basket. On July 31, 1998, and October 9, 1998, respectively, the Exchange submitted Amendments Nos. 1<sup>3</sup> and 2<sup>4</sup> to the proposed rule change to the Commission.

The proposed rule change, including Amendment No. 1, was published for comment in the **Federal Register** on August 26, 1998.<sup>5</sup> No comments were received on the proposal. This order approves the proposal as amended.

#### II. Description of the Proposal

The Amex proposes to trade Stock Upside Note Securities ("SUNS") on the Lehman Brothers European Stock Basket ("Basket"), a new basket of stocks developed by Lehman Brothers Holdings, Inc. ("Lehman Brothers") based entirely on the shares of European companies. SUNS on the Basket are designed to allow investors to combine the protection of a portion of the principal amount of the SUNS with a potential additional payment based upon the performance of a portfolio of highly capitalized European stocks. In particular, the proposed SUNS will

provide at least 90% principal protection with the opportunity to participate in any upside appreciation of the Basket, subject to any cap on appreciation that may be included by the issuer.

#### Criteria Under Section 107A of the Amex Company Guide

Under section 107A of the *Amex Company Guide*, the Exchange may approve for listing and trading securities that can not be readily categorized under the listing criteria for common and preferred stocks, bonds, debentures or warrants.<sup>6</sup> SUNS issues on the Basket will conform to the listing guidelines under Section 107A of the *Amex Company Guide*, which provide, among other things, that the issuer shall satisfy the earnings criteria set forth in Section 101<sup>7</sup> of the *Amex Company Guide* and have assets in excess of \$100 million and stockholders' equity of at least \$10 million. Where the issuer does not satisfy the earnings criteria set forth in Section 101 of the *Amex Company Guide*, the issuer must have assets in excess of \$200 million and stockholders' equity of at least \$10 million; or have assets in excess of \$100 million and stockholders' equity of at least \$20 million. Further, SUNS will have a minimum public distribution of 1,000,000 units with a minimum of 400 public shareholders, except, if traded in thousand dollar denominations, then no minimum number of holders will be required. SUNS will have a principal amount/aggregate market value of not less than \$4 million. In addition, Amex will apply the continued listing guidelines for the proposed SUNS as set forth in Sections 1001 through 1003 of the *Amex Company Guide*. In particular, Section 1003(b)(iii) regarding suspensions and delistings with respect to limited distribution and reduced market value bonds will apply to the SUNS.

The SUNS are non-convertible debt securities of Lehman Brothers and will conform to the above listing standards. Although the specific maturity date will

not be established until immediately prior to the time of the offering, the SUNS will provide for maturity within a period of not less than two years and not more than seven years from the date of issue. The SUNS will provide for a single payment at maturity, and will bear no periodic payments of interest. The European Stock Basket SUNS will be denominated in U.S. dollars and will entitle the owner at maturity to receive an amount based on the percentage change between the "Original Portfolio Value" and the "Ending Average Portfolio Value," provided: (1) the amount payable at maturity will not be less than 90% of the principal amount of the SUNS; and (2) the issuer may place a cap on the maximum amount of be paid on the SUNS at maturity. Thus, holders of the SUNS may not receive the full amount of the appreciation of the Ending Average Portfolio Value over the Original Portfolio Value. For example, Lehman Brothers may place a cap on the amount to be received at maturity as a stated percentage of the issuance price, e.g., 150% of the issuance price. Alternatively, a cap could be in the form of a participation rate whereby a holder of the SUNS would participate in a stated percentage of the total percentage change between the Ending Portfolio Value and the Original Portfolio Value, e.g., 80% of the total appreciation of the European Stock Basket during the term of the SUNS. The Original Portfolio Value is the value of the European Stock Basket on the date on which the issuer prices the SUNS for the initial offering to the public. The Ending Average Portfolio Value is the average of the closing prices of the European Stock Basket securities for a ten-day period beginning on the twelfth trading day prior to maturity of the SUNS. The European Stock Basket SUNS will be cash-settled and will not give holders any right to receive any Basket security or any other ownership right or interest in such security even though the return on the investment is based on the value of the Basket.

#### The SUNS Basket and Components

The European Stock Basket will consist of not less than ten nor more than thirty stocks of highly capitalized European companies.<sup>8</sup> Each stock included in the Basket will meet the following criteria: (1) a market capitalization in excess of \$75 million;

<sup>8</sup> The Exchange represents that once a determination is made by Lehman Brothers as to which securities will be included in the Basket, the Exchange will provide a list of those securities to the Commission. This list will be provided prior to the commencement of trading of the SUNS on the Basket. See Amendment No. 2, *supra* note 4.

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

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

<sup>3</sup> See letter from Claire P. McGrath, Vice President and Special Counsel, Derivatives Legal Counsel, Amex, to Richard Strasser, Assistant Director, Division of Market Regulation ("Division"), SEC dated July 30, 1998 ("Amendment No. 1").

<sup>4</sup> See letter from Claire P. McGrath, Vice President and Special Counsel, Derivatives Legal Counsel, Amex, to Richard Strasser, Assistant Director, Division, SEC, dated October 8, 1998 ("Amendment No. 2").

<sup>5</sup> Securities Exchange Act Release No. 40338 (August 19, 1998), 63 FR 45539.

<sup>6</sup> The Commission has previously approved the listing and trading of hybrid securities similar to SUNS based upon portfolios of securities or stock indices. See e.g., Securities Exchange Act Release Nos. 32840 (September 2, 1993), 58 FR 47485 (September 9, 1993); 33368 (December 22, 1993), 58 FR 68975 (December 29, 1993); 33495 (January 19, 1994), 59 FR 3883 (January 27, 1994); 34692 (September 20, 1994), 59 FR 49267 (September 27, 1994); 37533 (August 7, 1996), 61 FR 42075 (August 13, 1996); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) ("Term Notes Approval Orders").

<sup>7</sup> Section 101 of the *Amex Company Guide* requires issuers to have pre-tax earnings of at least \$750,000 in the last fiscal year of two of the last three fiscal years.

alternatively, the lowest weighted securities in the Basket that do not account for more than 10% of the weight of the Basket, may have a market capitalization of \$50 million or greater; (2) the trading volume of each component in the Basket will be at least one million shares during each of the six months preceding the listing of the SUNS; alternatively, the lowest weighted securities in the Basket that do not account for more than 10% of the weight of the Basket, may have a volume of at least 500,000 shares during each of the six months preceding the listing of the SUNS; (3) the market price for each component stock used for the calculation of the Basket will be obtained from the stock's primary market; and (4) the market price for each component will be at least \$5 for the majority of business days during the three calendar months preceding the listing of the SUNS.

#### *Basket Calculation*

The Basket will be calculated using the modified equal-dollar weighting methodology. Thus, prior to the issuance of the SUNS, Lehman Brothers will establish a weighting for each of the securities in the Basket. Specifically, each security included in the Basket will be assigned a multiplier so that the security represents the established percentage of the value of the entire Basket on the date of issuance. The multiplier indicates the number of shares (or fraction of one share) of a security, given its market price, to be included in the calculation of the Basket. The weightings established for each security will assure that: (1) no single stock will represent more than 25% of the weight of the Basket; (2) the five highest weighted stocks will represent no more than 50% of the weight of the Basket; (3) foreign country securities that are not subject to comprehensive surveillance agreements will not in the aggregate represent more than 40% of the weight of the Basket; (4) stocks for which the primary market is in any one country that is not subject to a comprehensive surveillance agreement do not represent 20% or more of the weight of the Basket; and (5) stocks for which the primary market is in any two countries that are not subject to the comprehensive surveillance agreements do not represent 33% or more of the weight of the Basket.

The multiplier of each security of the Basket will generally remain unchanged except for adjustments that may be necessary as a result of stock splits or

stock dividends.<sup>9</sup> There will be no adjustments to the multipliers to reflect cash dividends paid with respect to a portfolio security. In addition, no adjustments of any multiplier of a portfolio security will be made unless such adjustment would require a change of at least 1% in the multiplier then in effect. If the issuer of a security included in the Basket no longer exists, whether for reason of a merger, acquisition or similar type of corporate control transaction, Lehman Brothers will assign to that security a value equal to the security's final value for the purposes of calculating portfolio values.

If the issuer of a European Stock Basket security is in the process of liquidation or subject to a bankruptcy proceeding, insolvency, or other similar adjudication, such security will continue to be included in the Basket so long as a market price for such security is available. If such a market price is no longer available for a Basket security due to a liquidation, bankruptcy, insolvency, or any other similar proceeding, then the value of the security will be zero in connection with calculating the daily Basket value and the Ending Average Portfolio Value, for so long as no such market price exists for that security. Lehman Brothers will not attempt to find a replacement stock, or to compensate in a manner other than what is set forth above, for the extinction of a security due to a bankruptcy or similar event.

The value of the Basket will be disseminated every 15 seconds from 9:30 a.m. until 4:00 p.m. each trading day by the Exchange. Such disseminated value will be calculated by the Amex or by an independent calculation agent appointed by Lehman Brothers. The Basket value will be calculated based on real-time prices during the hours the European markets overlap trading hours with the Exchange. After the close of the European markets, the Basket value will be calculated based on the last sale price of the component security. The Basket will be calculated using the last sale value for each component security from its primary market place. The exchange rate for each currency represented in the Basket will be from one of two sources: (i) the WM/Reuters closing value reported in London at about 12:00 (New York time) each trading day or (ii) the best bid and offer price posted by two or more contributing banks as provided

<sup>9</sup> The Exchange represents that the independent calculation agent will be responsible for making any changes to the multiplier that become necessary due to a stock split or dividend. See Amendment No. 2, *supra* note 4.

by Bridge/Telesphere.<sup>10</sup> If the market place for any one of the securities constituting the European Stock Basket has not opened for trading on any given business day, the previous closing value will be used in the calculation. The Basket value, for any day, will equal the sum of the products of the most recently available market prices, expressed in U.S. dollars and the applicable multipliers for the Basket securities. Lehman Brothers will undertake to implement certain surveillance and compliance procedures with respect to the dissemination of the Basket value, requiring that the Basket value be announced only through public dissemination and restricting the access of the Lehman Brothers trading desk to the Basket value determined by the calculation agent until after public dissemination of that value.

#### *Exchange Rules Applicable to SUNS*

The Exchange's equity trading rules will apply to the trading of SUNS linked to the European Stock Basket. Those rules include Rule 411, which requires members to use due diligence to learn the essential facts relative to every customer and to every order or account accepted; and Rule 462 which requires the application of equity margin rules to the trading of indexed term notes. The Exchange will, prior to trading the proposed SUNS, distribute an Information Circular to the membership: (1) highlighting the essential features of the SUNS product including, but not limited to, if applicable, the less than 100% principal protection feature and the fact that the issuer has placed a cap on the amount to be paid on the SUNS at maturity; and (2) providing guidance with regard to member firm compliance responsibilities (including suitability recommendations) when handling transactions in the SUNS and highlighting their special risks and characteristics. The circular will state that before a member, member organization, or employee of such member organization undertakes to recommend a transaction in the security, such member or member organization should make a determination that the security is suitable for such customer and the person making the recommendation should have a reasonable basis for believing at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that they may be capable of evaluating the risks and the special characteristics of the recommended transaction, including

<sup>10</sup> See Amendment No. 2, *supra* note 4.

those highlighted, and is financially able to bear the risks of the recommended transaction.

### III. Discussion

The Commission finds that the proposed rule change is consistent with 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) of the Act.<sup>11</sup> Specifically, the Commission believes that providing for exchange-trading of SUNS on the Basket<sup>12</sup> will offer a new and innovative means of participating in the market for highly capitalized European stocks. In particular, the Commission believes that SUNS on the Basket will permit investors to gain equity exposure in such companies, while, at the same time, limiting the downside risk of the original investment due to the principle guarantee feature.<sup>13</sup> Accordingly, for the same reasons as discussed in the Term Notes Approval Orders,<sup>14</sup> the Commission finds that the listing and trading of SUNS on the Basket is consistent with the Act.<sup>15</sup>

As with other derivative products similar to SUNS, SUNS on the Basket are not leveraged instruments; however, their price will still be derived from and based upon the underlying linked security. Accordingly, the level of risk involved in the purchase or sale of SUNS on the Basket is similar to the risk involved in the purchase or sale of traditional common stock. Nonetheless, because the final rate of return of SUNS is derivatively priced, based on the performance of a portfolio of securities, there are several issues regarding the trading of this type of product.

The Commission believes that the Exchange has adequately addressed these issues for several reasons. First, the Commission notes that the

Exchange's rules and procedures that address the special concerns attendant to the trading of hybrid securities will be applicable to SUNS on the Basket. In particular, by imposing the hybrid listing standards, and the suitability, disclosure, and compliance requirements noted above, the Commission believes the Exchange has addressed adequately the potential problems that could arise from the hybrid nature of SUNS on the Basket. Moreover, the Exchange will distribute a circular to its membership calling attention to the specific risks associated with SUNS on the Basket. In particular, the circular will highlight, among other things, that the SUNS on the Basket allow investors to participate in appreciation only to the extent that the Basket outperforms the initial Basket value based on the average of the closing prices of the European Stock Basket securities for a ten-day period beginning on the twelfth trading day prior to maturity of the SUNS and any cap on appreciation.

Second, SUNS on the Basket remain a non-leveraged product with the issuer guaranteeing no less than 90 percent of principal return.<sup>16</sup> The Commission realizes that the final payout on the SUNS on the Basket is dependent in part upon the individual credit of the issuer. To some extent this credit risk is minimized by the Exchange's listing standards in Section 107A of the *Amex Company Guide* which provides that only issuers satisfying substantial asset and equity requirements may issue securities such as SUNS.<sup>17</sup> In addition, the Exchange's hybrid listing standards further require that the proposed indexed term notes have at least \$4 million in market value.<sup>18</sup> In any event, financial information regarding the issuer, in addition to information on the underlying securities, will be publicly available to investors.

Third, the component securities in the Basket are highly-capitalized, actively-traded European stocks. In addition, the components are all publicly traded on the home country's primary market. Accordingly, both the history and performance of these securities, as well as current pricing trends, should be readily available through a variety of public sources.

Further, the Commission notes that the value of the Basket will be disseminated on a real time basis at least once every 15 seconds throughout the trading day. As noted above, to the extent that European and U.S. market hours overlap, last sale prices on the primary market will be used to calculate the value of the Basket. The Commission believes that this information will be extremely useful and beneficial for investors in SUNS on the Basket.

Although the SUNS are denominated in U.S. dollars, as noted above, the Basket value will be derived from converting the value of each security from its home currency into U.S. dollars. The Exchange represents that the calculation agent will determine, prior to the listing of the SUNS on the Basket, which source it will use.<sup>19</sup> The currency conversion of the Basket will have a significant effect on both the intraday value of the Basket as well as the ultimate payout at settlement. Accordingly, the currency conversion methodology must be fair and accurate and applied in a consistent manner. In this regard, the Commission expects the Amex to carefully monitor and surveil the currency conversion method, as well as the prices of the foreign securities used in the conversion, to ensure the fairness and accuracy of valuing the Basket, especially at settlement.

Fourth, while the Commission has a systematic concern that a broker-dealer or a subsidiary providing a hedge for the issuer will incur position exposure, the Commission believes this concern is minimal given the size of the proposed SUNS issuance in relation to the net worth of the issuer.<sup>20</sup>

Finally, the Exchange's surveillance procedures will serve to deter as well as detect any potential manipulation. As discussed above, Amex represents that: (1) foreign country securities that are not subject to comprehensive surveillance agreements will not in the aggregate represent more than 40% of the weight of the Basket; (2) stocks for which the primary market is in any one country that is not subject to a comprehensive surveillance agreement do not represent 20% or more of the weight of the Basket; and (3) stocks for which the primary market is in any two

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> The Commission notes that this approval order is limited to the SUNS product; separate Commission approval may be required for the Exchange to list and trade any other derivative product based on the Lehman Brothers European Stock Basket.

<sup>13</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of exchange trading of new products upon a finding that the introduction of such new derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument 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.

<sup>14</sup> See Term Notes Approval Orders, *supra* note 6.

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

<sup>16</sup> The Commission notes that the Amex may not list for trading SUNS with less than a 90% principal guarantee without first consulting with the Commission. For example, the Commission may determine that SUNS with less than a 90% principal guarantee should only be sold to customers meeting certain heightened account approval and suitability requirements.

<sup>17</sup> See *supra* note 7 and accompanying text.

<sup>18</sup> See *Amex Company Guide* § 107A.

<sup>19</sup> As noted above, the currency conversion will be from one of two sources: (i) the WM/Reuter closing value reported in London at about 12:00 (New York time) each trading day or (ii) the best bid and offer price posted by two or more contributing banks as provided by Bridge/Telesphere. The Commission expects that, once chosen, the calculation agent will not change the source it uses to convert currency values during the life of the SUNS on the Basket.

<sup>20</sup> See Term Notes Approval Orders, *supra* note 6.

countries that are not subject to the comprehensive surveillance agreements do not represent 33% or more of the weight of the Basket. Further, if the surveillance coverage should fall below certain levels, as discussed above, no new SUNS will be listed. The Commission believes that this should help to ensure that adequate surveillance mechanisms exist in the future.

The Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. In Amendment No. 2, the Exchange indicates that: (1) either the Amex or an independent calculation agent will calculate the value of the Basket; (2) the calculation agent will, if necessary, determine the changes in the multipliers of the securities in the Basket; (3) the calculation agent will only use the Bridge/Telesphere source for currency conversion rates if it is able to obtain the bid and offer prices from two or more contributing banks for each currency; and (4) the Exchange will notify the Commission once Lehman Brothers determines which securities will be included in the Basket. The Commission does not believe that Amendment No. 2 raises any regulatory issues that were not addressed by the Term Notes Approval Orders. In addition, to the extent that the Basket has certain characteristics that differ from the previous Term Notes Approval Orders, the Commission believes that the Amex has adequately addressed those issues. In this regard, as to the use of Bridge/Telesphere for currency conversion rates, the Amendment will help to ensure that such source will only be used when there are a minimum number of bids and offers available. The Commission notes that this proposal was published for the full notice and comment period during which no comments were received. Accordingly, the Commission believes that good cause exists, consistent with Section 6(b)(5) <sup>21</sup> and Section 19(b)(2) <sup>22</sup> of the Act, to grant accelerated approval to the proposed rule change.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission,

450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to File No. SR-Amex-98-25 and should be submitted by January 4, 1999.

#### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>23</sup> that the proposed rule change (SR-Amex-98-25) is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>24</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-33072 Filed 12-11-98; 8:45 am]

BILLING CODE 8010-01-M

#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40755; File No. SR-NASD-98-90]

#### Self-Regulatory Organizations, Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to the Code of Procedure to Provide for the Office of Disciplinary Affairs of NASD Regulation, Inc. to Authorize all Enforcement Actions

December 7, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") <sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 4, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary NASD Regulation ("NASDR"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been

prepared by NASDR.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASDR proposes to amend Rules 9120 and 9211 of the NASD's Code of Procedure to enable the Office of Disciplinary Affairs of NASDR to authorize all disciplinary actions. Below is the text of the proposed rule change. Proposed new language is italicized, proposed deletions are in brackets.

\* \* \* \* \*

#### 9120. Definitions.

(a) through (d).

No change.

(e) "Department of Enforcement"

The term "Department of Enforcement" means the Department of Enforcement or its delegatee, the Department of Market Regulation[, except that the term excludes the Department of Market Regulation with respect to the action of:

(1) authorizing a complaint under Rule 9211;

(2) determining the terms of a letter of acceptance, waiver, and consent or the terms of a minor rule violation plan letter under Rule 9216;

(3) determining whether to contest an offer of settlement under Rule 9270; and

(4) authorizing the filing of an appeal under Rule 9311]. (f) through (u).

No change.

(v) "Office of Disciplinary Affairs"

The term "Office of Disciplinary Affairs" means the Office of Disciplinary Affairs for NASD Regulation.

(w) [v] "Panelist"

No change.

(x) [w] "Party"

No change.

(v)[x] "Primary District Committee"

No change.

(z)[y] "Respondent"

No change.

(aa)[z] "Review Subcommittee"

No change.

(bb)[aa] "Statutory Disqualification Committee"

No change.

(cc)[bb] "Subcommittee"

No change.

\* \* \* \* \*

#### 9200. DISCIPLINARY PROCEEDINGS

#### 9210. Complaint and Answer

<sup>3</sup> Several non-substantive changes were provided by the NASDR in a telephone conversation between Eric Moss, Office of General Counsel, NASDR, and Joseph Corcoran, Division of Market Regulation, Commission, on December 7, 1998.

<sup>21</sup> 15 U.S.C. 78f(b)(5).

<sup>22</sup> 15 U.S.C. 78s(b)(2).

<sup>23</sup> 15 U.S.C. 78s(b)(2).

<sup>24</sup> 17 CFR 200.30-3(a)(12).

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

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