securities.[38] Although the Commission continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Friday helps alleviate stock market volatility,[39] these market impact concerns are reduced in the case of FLEX options on the DJUA because expiration of these options will not correspond to the normal expiration of any non-FLEX options (including options overlying the DJUA), stock index futures, and options on stock index futures. In particular, FLEX options, will never expire on any ''Expiration Friday'' because the expiration date of a FLEX option may not occur on a day that is on, or within, two business days of the expiration date of a Non-FLEX option. The Commission believes that this should reduce the possibility that the exercise of FLEX options at expiration will cause any additional pressure on the market for underlying securities at the same time that Non-FLEX options expire.

Nevertheless, because the position limits for FLEX index options on the DJUA are much higher than those currently proposed for the corresponding non-FLEX Index options (*i.e.*, 4 times the existing 15,000 contract limit) and open interest in one or more FLEX option series could grow to significant levels, it is possible that FLEX options on the DJUA might have an impact on the securities markets for the securities underlying FLEX options. The Commission expects the Exchange to monitor the actual effect of FLEX options on the DJUA once trading commences and take prompt action (including timely communication with the self-regulatory organizations responsible for oversight of trading in the underlying securities) should any unusual market effects develop.

F. Accelerated Approval of Amendment No. 1

The Commission finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 1, does raise any novel issues. It merely states that the Exchange will notify the Commission in the event that the Index fails to meet a set of maintenance standards that are substantially similar to existing maintenance standards for narrow-based indices. These representations are identical in all material respects to those made by the Exchange in connection with similar proposals to list options on stock indexes. In addition, Amendment No. 1 sets position limits for FLEX options at 4 times the limits applicable for industry index options and includes an attached letter from Dow Jones & Company describing their procedures for replacing Index components and outlining their conflict of interest policy. The Commission believes, therefore, that Amendment No. 1 further strengthens and clarifies the proposal, and raises no new regulatory issues. Further, the Commission notes that the original proposal was published for the full 21-day comment period and no comments were received by the Commission. Accordingly, the Commission believes it is consistent with Sections 19(b)(2) and 6(b)(5) of the Act to approve Amendment No. 1 to the Exchange's proposal on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1. 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–CBOE–97–28 and should be submitted by October 2, 1997.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[40] that the proposed rule change (SR–CBOE–97–28) is approved, as amended. In addition, for purposes of trading FLEX options on the Index, the Commission also finds, pursuant to Rule 9b–1 under the Act, that such options are standardized options for purposes of the options disclosure framework established under Rule 9b–1.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[41]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–24039 Filed 9–10–97; 8:45 am]

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[38] *See, e.g.*, Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

[39] *Id.*

[40] 15 U.S.C. 78s(b)(2).

[41] 17 CFR 200.30–3(a) (12) and (51).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39012; File No. SR–CBOE–97–27]

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

September 3, 1997.

I. Introduction

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

The proposed rule change was published for comment in the **Federal Register** on July 8, 1997.[3] No comments were received on the proposal. On August 12, 1997, the CBOE submitted Amendment No. 1 to the proposed rule change.[4] This order approves the

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 38790 (June 30, 1997), 62 FR 36592 (July 8, 1997).

[4] In Amendment No. 1, the CBOE represents that it will notify the Commission if the Index fails to meet maintenance standards substantially similar to those in CBOE Rule 24.2. In addition, Amendment No. 1 states that the position limits for FLEX options will be set at 4 times the limits applicable for industry index options set forth in Rule 24.2(A)(a)(i). Finally, Amendment No. 1, in an attached letter from Dow Jones, describes their procedures for replacing Index components and outlines their conflict of interest policy. *See* letter from Eileen Smith, Director, Product Development, CBOE to John Ayanian, Special Counsel, Division of Market Regulation, SEC dated August 1, 1997 (Amendment No. 1).

proposal, as amended, and solicits comment on Amendment No. 1.

II. Description of the Proposal

A. General

The CBOE proposes to list and trade options on the Dow Jones Transportation Average (''DJTA'' or ''Index''), an index developed by Dow Jones & Company. The options on the Index will be based on one-tenth of the value of the Index. The CBOE also proposes to list LEAPS on a one-tenth value index level (''full value LEAPS'') and reduced-value LEAPS on the Index.[5] For reduced value LEAPS, the underlying value would be computed at one-one-hundredth of the Index level, or one-tenth of the value of full-value options. Reduced or full value LEAPS will trade independent of and in addition to regular Index options traded on the CBOE. The CBOE will also provide for the trading of FLEX Options on the Index.[6]

B. Composition of the Index

The DJTA was first calculated on September 8, 1996, and is based on 20 of the largest, most liquid U.S. transportation industry stocks. Eighteen of the stocks in the Index currently trade on the New York Stock Exchange, Inc., (''NYSE'') and two trade through the facilities of the National Association of Securities Dealers Automated Quotation System (''Nasdaq'').[7] All of the component stocks are ''reported securities'' as that term is defined in Rule 11Aa3–1 of the Act.[8] The Index is price weighted and will be calculated on a real-time basis using last sale prices.

As of the close of trading on June 5, 1997, the Index had a closing value of 2683.55.[9] Also, as of the close of trading on June 5, 1997, the market capitalizations of the individual securities in the Index ranged from a high of $16.7 billion (Union Pacific Corp.) to a low of $352 million (Alaska Air Group, Inc.), with a mean and median of $5.1 billion and $2.5 billion, respectively. The total market capitalization of the securities in the index was $101.9 billion. The total number of shares outstanding for the issuers in the index range from a high of 244 million shares (Union Pacific Corp.) to a low of 14 million shares (Alaska Air Group, Inc.). The price per share of the securities in the Index ranged from a high of $97.625 (AMR Corp.) to a low of $19.625 (Yellow Corp.) with a six-month mean and median, for the period ending June 5, 1997 of $49.475 and $36.813, respectively. In addition, the average daily trading volume for securities in the Index ranged from a high of 971,439 shares (US Airways Group, Inc.) to a low of 17,242 shares (XTRA Corp.), with the mean and median 379,153 and 336,908, respectively. Lastly, no one security accounted for more than 9.87 percent of the Index's total value (AMR Corp.), and the percentage weighting of the five largest issues in the Index accounted for 45.02 percent of the Index's value. The percentage weighting of the lowest weighted component was 1.98 percent (Yellow Corp.) and the percentage weighting of the five smallest issues accounted for 12.8 percent of the Index's value. Finally, all of the component stocks in the Index are options eligible and currently the subject of trading in equity options.

C. Maintenance

Dow Jones & Company is responsible for maintenance of the DJTA. Dow Jones & Company may change the composition of the Index at any time to reflect the conditions in the transportation industry. The Managing Editor of the Wall Street Journal is responsible for component additions and deletions. The components of the Index are not formally reviewed on any set schedule. The Managing Editor of the Wall Street Journal selects stocks that he believes best reflect the transportation sector of the economy and of the stock market. The Managing Editor usually consults one to three senior editors of The Wall Street Journal about prospective changes. Though various data might be gathered for reference, this is a subjective decision. Index maintenance includes monitoring and completing the adjustments for company additions and deletions, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to company restructuring or spinoffs. In almost all instances, a stock is removed immediately from the DJTA when the company files for protection under bankruptcy laws. If required, the Index Divisor will be adjusted to account for any of the above changes. Changes to the Index are announced in the Wall Street Journal and through the Dow Jones News Service generally two to three trading days prior to implementation. Generally, Index components are replaced infrequently. The Index is currently composed of 20 stocks and it is expected that it will remain at 20.

The Exchange has represented that it will notify the Commission in the event that the following maintenance criteria are not met: (1) The market value of any component stock is less than $75 million except that the lowest weighted components comprising not more than 10% of the weight of the index cannot have market values less than $50 million; (2) less than 90% of the weight of the Index is represented by component stocks that are options eligible or less than 80% of the number of components are options eligible; (3) 10% or more of the weight of the index is represented by stocks trading less than 15,000 shares per day over the previous 6 month period; (4) the largest component stock accounts for more than 25% of the weight of the index or the largest 5 component stocks in the aggregate account for more than 60% of the weight of the index and (5) the number of stocks in the index is increased or decreased by more than ⅓.

D. Applicability of CBOE Rules Regarding Index Options

As modified herein, the rules in Chapter XXIV of the CBOE Rules will be applicable to DJTA Index options, full-value and reduced-value Index LEAPS and FLEX options. Those rules address, among other things, the applicable position and exercise limits, policies regarding trading halts and suspensions, and margin treatment for narrow-based index options.

E. Calculation of the Index

The DJTA is a price-weighted index. The level of the Index reflects the total price of the component stocks divided by the Index Divisor.The daily calculation of the DJTA is computed by dividing the aggregate price of the companies in the Index by the Index Divisor. The Divisor keeps the Index comparable over time and is adjusted periodically to maintain the Index. The values of the Index will be calculated continuously by Dow Jones & Company

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[5] ''LEAPS'' is an acronym for Long-Term Equity Anticipation Securities. LEAPS are long-term index option series that expire from 12 to 36 months from their date of issuance. *See* CBOE Rule 24.9(b)(1).

[6] FLEX options are standardized options that provide investors with the ability to customize basic option features, including size, expiration date, exercise style, and exercise price.

[7] The JDTA currently consists of the following companies: Airborne Freight Corp., Alaska Air Group, Inc., AMR Corp., APL Ltd., Burlington Northern Santa Fe Corp., Caliber System, Inc., CNF Transportation, Inc., CSX Corp., Delta Air Lines, Inc., Federal Express Corp., Illinois Central Corp., Norfolk Southern Corp. Ryder System, Inc., Southwest Airlines Co., US Airways Group, Inc., UAL Corp., Union Pacific Corp., US Freightways Corp., XTRA Corp. and Yellow Corp.

[8] *See* 17 CFR 240.11Aa3–1. A ''reported security'' is defined in paragraph (a)(4) of this Rule as ''any listed equity security or NASDAQ security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan.''

[9] The DJTA was first calculated on September 8, 1896 and the index value was 48.55 on that date.

or its designee and will be disseminated at 15-second intervals during regular CBOE trading hours to market information vendors via the Options Price Reporting Authority (''OPRA'') or the Consolidated Tape Association.

F. Contract Specifications

The proposed options will be cash-settled, European-style options.[10] The trading hours for options on the Index will be from 8:30 a.m. to 3:02 p.m. Chicago time. Strike prices will be set to bracket the index in 2½ point increments or greater. In addition, pursuant to CBOE Rule 24.9, there may be up to six expiration months outstanding at any given time. Specifically, there may be up to three expiration months from the March, June, September, and December cycle, plus up to three additional near-term months so that the two nearest-term months will always be available. As described in more detail below, the Exchange also intends to list several Index LEAPS series that expire from 12 to 36 months from the date of issuance.

G. Settlement of Index Options

The proposed options on the Index will expire on the Saturday following the third Friday of the expiration month. Trading in the expiring contract month will normally cease at 3:02 p.m. (Chicago time) on the business day preceding the last day of trading in the component securities of the Index (ordinarily the Thursday before expiration Saturday, unless there is an intervening holiday). The exercise settlement value of the Index at option expiration will be calculated by Dow Jones based on the opening prices of the component securities on the business day prior to expiration. If a stock fails to open for trading, the last available price on the stock will be used in the calculation of the index, as is done for currently listed indexes.[11] When the last trading day is moved because of Exchange holidays (such as when CBOE is closed on the Friday before expiration), the last trading day for expiring options will be Wednesday and the exercise settlement value of Index options at expiration will be determined at the opening of regular Thursday trading.

H. Listing of Long-Term Options on the Full-Value or Reduced Value DJTA Index

The Exchange's proposal provides that the Exchange may list longer term option series having up to thirty-six months to expiration on one-tenth (1/10th) the Index's full value, which is the same value used to calculate regular options on the Index. In lieu of such long-term options on a one-tenth value Index level, the Exchange may instead list long-term, reduced value put and call options based on one-one-hundredth (1/100th) the Index's full value. The current and closing index value of any such reduced-value LEAP will, after such initial computation, be rounded to the nearest one-hundredth. In either event, the interval between expiration months for either a long-term option or reduced value long-term option will not be less than six months. The trading of any long term options would be subject to the same rules which govern the trading of all the Exchange's index options, including sales practice rules, margin requirements and floor trading procedures and all options will have European-style exercise.

I. FLEX Option Trading

The Exchange proposes to list FLEX Index options on the DJTA. FLEX options give investors the ability, within specified limits, to designate certain of the terms of the options. In recent years, an over-the-counter (''OTC'') market in customized options has developed which permits participants to designate the basic terms of the options, including size, term to expiration, exercise style, exercise price, and exercise settlement value, in order to meet their individual investment needs. Participants in this OTC market are typically institutional investors, who buy and sell options in large-size transactions through a relatively small number of securities dealers. To compete with this growing OTC market in customized options, the CBOE permits FLEX index options trading in an exchange auction market environment, with OCC as issuer and guarantor.[12] The Exchange's proposal will allow FLEX option market participants to designate the following contract terms for FLEX options on the DJTA: (1) Exercise price; (2) exercise style (*i.e.*, American,[13] European,[14] or capped[15]); (3) expiration date,[16] (4) option type (put, call, or spread); and (5) form of settlement (A.M., P.M. or average).

The Exchange is proposing changes to its FLEX rules to provide for the trading of FLEX options on the DJTA. The proposed changes include an amendment to the FLEX Option position limits. Position limits would be as established by the Exchange but in no event would be greater than four times the limits for standard options on the DJTA.[17]

J. Position and Exercise Limits, Margin Requirements, and Trading Halts

The proposal provides that Exchange rules that are applicable to the trading of narrow-based index options will apply to the trading of options on the Index. Specifically, Exchange rules governing margin requirements,[18] position and exercise limits,[19] and trading halt procedures[20] that are applicable to trading of narrow-based

[10] A European-style option can be exercised only during a specified period before the option expires.

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

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

[13] An American-style option is one that may be exercised at any time on or before the expiration date.

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

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

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

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

[18] Pursuant to CBOE Rule 24.11, the margin requirements of the Index options will be: (1) For short positions, 100% of the current market value of the options contract plus 20% of the underlying aggregate Index value, less any out-of-the-money amount, with a minimum requirement of the options premium plus 10% of the underlying Index value; and (2) for long term options positions, 100% of the options premium paid.

[19] Pursuant to CBOE Rules 24.4A and 24.5, respectively, the position and exercise limits for the Index options will be 15,000 contracts, unless the Exchange determines, pursuant to Rules 24.4A and 24.5 that a lower limit is warranted.

[20] Pursuant to CBOE Rule 24.7, the trading of options on the Index will be halted or suspended whenever trading in underlying securities whose weighted value represents more than 20% of the Index's value is halted or suspended.

index options will apply to options traded on the Index. Position limits on reduced value long-term DJTA Index options will be equivalent to the position limits for regular (full value) Index options and would be aggregated with such options (for example, if the position limit for the full value options is 15,000 contracts on the same side of the market, then the position limit for the reduced value options will be 150,000 contracts on the same side of the market).

K. Surveillance

Surveillance procedures currently used to monitor trading in each of the Exchange's other index options will also be used to monitor trading in options on the Index. These procedures include complete access to trading activity in the underlying securities. Further, the Intermarket Surveillance Group (''ISG'') Agreement, dated July 14, 1983, as amended on January 29, 1990, will be applicable to the trading of options on the Index.[21]

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

III. Findings and Conclusions

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange,[23] and, in particular, with the requirements of Section 6(b)(5).[24] Specifically, the Commission finds that the trading of options on the Index, including Index LEAPS, reduced value Index LEAPS, and FLEX options, will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with an additional means to hedge exposure to market risk associated with stocks in the transportation sector.[25] The trading of options in the DJTA, however, raises several issues relating to index design, investor protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that CBOE has adequately addressed the issues.

A. Index Design and Structure

The DJTA is comprised of only twenty stocks, all of which are within one industry segment, the transportation industry segment. Accordingly, the Commission believes that it is appropriate for the CBOE to apply its rules governing narrow-based index options to trading in the Index options including for margin and position and exercise limit purposes.[26]

The Commission also believes that the liquid markets, large capitalizations, and relative weightings of the Index's component stocks significantly minimize the potential for manipulation of the Index. First, as of June 5, 1997, the overwhelming majority of the stocks that comprise the Index are actively traded, with a mean and median daily trading volume 379,153 and 336,908 shares, respectively.[27] Second, the market capitalizations of the stocks in the Index are very large, ranging from $352 million to $16 billion, with the mean and median being $5 billion and $2.5 billion, respectively. Third, although the Index is only comprised of twenty component stocks, no one stock or group of stocks dominates the Index. Specifically, no one stock comprises more than 9.87% of the Index total value and the percentage weighting of the five largest issues in the Index accounts for 45.02% of the Index's value. Fourth, all of the stocks in the Index are currently the subject of equity option trading.[28] Fifth, the Exchange has represented that it will notify the Commission in the event that the following maintenance criteria are not met: (1) The market value of any component stock is less than $75 million except that the lowest weighted components comprising not more than 10% of the weight of the index cannot have market values less than $50 million; (2) less than 90% of the weight of the Index is represented by component stocks that are options eligible or less than 80% of the number of components are options eligible; (3) 10% or more of the weight of the index is represented by stocks trading less than 15,000 shares per day over the previous 6 month period; (4) the largest component stock accounts for more than 25% of the weight of the index or the largest 5 component stocks in the aggregate account for more than 60% of the weight of the index and (5) the number of stocks in the index is increased or decreased by more than ⅓. In the event the Index fails to satisfy any of the criteria, CBOE will notify the Commission to determine the appropriate regulatory response, including but not limited to, prohibiting opening transactions, removal of the securities from the Index, or discontinuing the listing of new series of Index options.[29] These maintenance

[21] ISG was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. *See* Intermarket Surveillance Group Agreement, July 14, 1983. The most recent amendment to the ISG Agreement, which incorporates the original agreement and all amendments made thereafter, was signed by ISG members on January 29, 1990. *See* Second Amendment 29, 1990. The members of the ISG are: the American Stock Exchange, Inc.; the Boston Stock Exchange, Inc.; the CBOE; the Chicago Stock Exchange, Inc.; the National Association of Securities Dealers, Inc.; the NYSE; the Pacific Stock Exchange, Inc.; and the Philadelphia Stock Exchange, Inc. Because of potential opportunities for trading abuses involving stock index futures, stock options, and the underlying stock, and the need for greater sharing of surveillance information for these potential intermarket trading abuses, the major stock index futures exchanges (e.g., the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

[22] *See* Amendment No. 1, *supra* supra note 4.

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

[24] 15 U.S.C. 78f(b)(5).

[25] Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option proposal 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. In this regard, the trading of listed options on the Index will provide investors with a hedging vehicle that should reflect the overall movement of the stocks representing companies in the transportation sector in the U.S. stock markets.

[26] *See* supra notes 18 through 20, and accompanying text.

[27] The Commission notes that one of the securities in the Index, XTRA Corp., had an average daily trading volume of 17,242 shares. To prevent the Index from being dominated by illiquid securities, the Exchange has agreed to notify the Commission in the event that 10% or more of the weight of the Index is represented by stocks trading less than 15,000 shares per day over the previous 6 month period. *See* note 29 and accompanying text.

[28] The CBOE's options listing standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) The public float must be at least 7,000,000; (2) there must be a minimum of 2,000 stockholders; (3) trading volume must have been at least 2.4 million over the preceding twelve months; and (4) the market price must have been at least $7.50 for a majority of the business days during the preceding three calendar months. *See* CBOE Rule 5.3.

[29] In addition, if the composition of the Index's underlying securities was to substantially change, the Commission's decision regarding the appropriateness of the Index's current maintenance standards would be reevaluated, and whether

Continued

standards should help protect against material changes in the composition and design of the Index that might adversely affect the CBOE's obligations to protect investors and to maintain fair and orderly markets in DJTA Index options.[30] Finally, the Commission believes these factors minimize the potential for manipulation because it is unlikely that attempted manipulations of the prices of the Index components would affect significantly the Index's value. Moreover, the surveillance procedures discussed below should detect as well as deter potential manipulation and other trading abuses.[31]

B. Customer Protection

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as options on the Index, can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) The special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because options on the Index will be subject to the same regulatory regime as the other standardized options currently traded on the CBOE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in options on the Index. Finally, replacements of component securities in the Index are published in the Wall Street Journal two to three trading days before they are implemented to notify the public of changes in the composition of the Index. The Commission believes this should help to protect investors and avoid investor confusion.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative products is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation.[32] In this regard, markets on which all of the components of the Index currently trade are members of the ISG, which provides for the exchange of all necessary surveillance information.[33]

As noted above, Dow Jones & Company also has a policy in place to prevent the potential misuse of material, non-profic information by members of the Wall Street Journal managerial and editorial staff in connection with the maintenance of the Index.[34]

D. Market Impact

The Commission believes that the listing and trading of options on the Index, including LEAPS, reduced-value LEAPS, and FLEX options, on the CBOE will not adversely impact the underlying securities markets.[35] First, as described above, due to the ''price weighting'' methodology, no one stock or group of stocks dominates the Index. Second, as noted above, the stocks contained in the Index have relatively large capitalizations and are relatively actively traded. Third, the currently applicable 15,000 contract position and exercise limits will serve to minimize potential manipulation and market impact concerns. Fourth, the risk to investors of contraparty non-performance will be minimized because the options on the index will be issued and guaranteed by OCC just like any other standardized exchange-listed option traded in the United States.

Lastly, the Commission believes that settling expiring options on the Index (including long-term full-value and reduced-value Index options) based on the opening prices of component securities is reasonable and consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than closing prices may help reduce adverse effects on markets for stocks underlying options on the Index.[36]

E. FLEX Options Trading

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

The Commission believes the Exchange's proposal reasonably addresses its desire to meet the demands of sophisticated portfolio managers and other institutional investors who are increasingly using the OTC market in order to satisfy their hedging needs. Additionally, the Commission believes that the Exchange's proposal will help promote the maintenance of a fair and orderly market, consistent with Sections 6(b)(5) and 11(a) of the Act, because the purpose of the proposal to list DJTA FLEX options is to extend the benefits of a listed, exchange market to index options that are more flexible than current listed options and that currently trade OTC.[37] The benefits of the Exchange's options market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, parameters and procedures for clearance and settlement, and the guarantee of OCC for all contracts traded on the Exchange.

The Commission notes that FLEX index options on the DJTA can be constructed with expiration exercise settlement based on the closing values of the component securities, which could potentially result in adverse effects for the markets in those securities.[38] Although the Commission continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Friday helps alleviate stock market volatility,[39] these market impact concerns are reduced in the case of FLEX options on the DJTA because expiration of these options will not correspond to the normal expiration of any non-FLEX options (including options overlying the DJTA), stock index futures, and options on stock

additional approval under Section 19(b) of the Act is necessary to continue to trade the product.

[30] These maintenance standards are similar to those applied to other index products. *See* CBOE Rule 24.2(c).

[31] The Commission believes that, even though the Index is price weighted, the high capitalization and active trading of a large majority of the component stocks helps address the manipulative concerns that may arise due to the price weighting.

[32] See Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992).

[33] *See supra* note 21 and accompanying text.

[34] *See* Amendment No. 1, *supra* note 4.

[35] In addition, CBOE and OPRA have represented that CBOE and OPRA have the necessary systems capacity to support those new series of index options that would result from the introduction of options on the Index. *See* Letter from Joe Corrigan, Executive Director, OPRA, to Eileen Smith, Director of Research and Product Development, CBOE, dated June 12, 1997.

[36] Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

[37] As noted above, FLEX options allow investors to customize certain terms, including size, term to expiration, exercise style, exercise price, and exercise settlement value.

[38] See, e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992).

[39] Id.

index futures. In particular, FLEX options will never expire on any ''Expiration Friday'' because the expiration date of a FLEX option may not occur on a day that is on, or within, two business days of the expiration date of a Non-FLEX option. The Commission believes that this should reduce the possibility that the exercise of FLEX options at expiration will cause any additional pressure on the market for underlying securities at the same time that Non-FLEX options expire.

Nevertheless, because the position limits for FLEX index options on the DJTA are much higher than those currently proposed for the corresponding non-FLEX Index (*i.e.,* 4 times the existing 15,000 contract limits) options and open interest in one or more FLEX option series could grow to significant levels, it is possible that FLEX options on the DJTA might have an impact on the securities markets for the securities underlying FLEX options. The Commission expects the Exchange to monitor the actual effect of FLEX options on the DJTA once trading commences and take prompt action (including timely communication with the self-regulatory organizations responsible for oversight of trading in the underlying securities) should any unusual market effects develop.

F. Accelerated Approval of Amendment No. 1

The Commission finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. Amendment No. 1, does not raise any novel issues. It merely states that the Exchange will notify the Commission in the event that the Index fails to meet a set of maintenance standards that are substantially similar to existing maintenance standards for narrow-based indices. These representations are nearly identical in all material respects to those made by the Exchange in connection with similar proposals to list options on stock indexes. In addition, Amendment No. 1 sets position limits for FLEX options at 4 times the limits applicable for industry index options and includes an attached letter from Dow Jones & Company describing their procedures for replacing Index components and outlining their conflict of interest policy. The Commission believes, therefore, that Amendment No. 1 further strengthens and clarifies the proposal, and raises no new regulatory issues. Further, the Commission notes that the original proposal was published for the full 21-day comment period and no comments were received by the Commission. Accordingly, the Commission believes it is consistent with Sections 19(b)(2) and 6(b)(5) of the Act to approve Amendment No. 1 to the Exchange's proposal on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1. 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–CBOE–97–27 and should be submitted by October 2, 1997.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[40] that the proposed rule change (SR–CBOE–97–27) is approved, as amended. In addition, for purposes of trading FLEX options on the Index, the Commission also finds, pursuant to Rule 9b–1 under the Act, that such options are standardized options for purposes of the options disclosure framework established under Rule 9b–1.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[41]

Margaret H. McFarland,

Deputy Secretary.

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[40] 15 U.S.C. 78s(b)(2).

[41] 17 CFR 200.30–3(a) (12) and (51).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39019; File No. SR–NASD–97–41]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Definition of Branch Office

September 4, 1997.

I. Introduction

On June 17, 1997,[1] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[2] and Rule 19b–4 thereunder,[3] a proposed rule change to amend Rule 3010 of the NASD's Conduct Rules to create another exception to the definition of branch office. A notice of the proposed rule change appeared in the **Federal Register** on July 2, 1997.[4] The Commission received two comment letters endorsing the proposed rule change.[5] The Commission is approving the proposed rule change.

II. Description of the Proposal

The definition of a branch office, found in NASD Rule 3010, includes any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, subject to several exceptions.[6] If a business location of a member meets the definition of a branch office, such office must be identified to the NASD through the filing of a Schedule E to

[1] The NASD granted an extension of the time for Commission action on this rule filing until thirty-five days after NASD Regulation filed an amendment advising of the action of the NASD Board of Governors. Letter from Craig L. Landauer, Associate General Counsel, NASD Regulation, Inc., to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated June 24, 1997. The NASD Board of Governors reviewed this proposed rule change on June 26, 1997. Letter from Craig L. Landauer, Associate General Counsel, NASD Regulation, Inc., to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated June 27, 1997.

[2] 15 U.S.C. § 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] Securities Exchange Act Release No. 38781 (June 26, 1997), 62 FR 35870.

[5] Letter from Allen W. Croessmann, President, BankBoston Investor Services, to Jonathan G. Katz, Secretary, SEC, dated July 22, 1997 and Letter from Joseph P. Savage, Assistant Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated July 22, 1997.

[6] *See* NASD Rule 3010(g)(2).