

with Morgan Stanley, upon the occurrence of certain events, the actual replacement stock will be selected solely by Amex from the 45 stocks on the replacement list.

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, and, in particular, the requirements of Section 6(b)(5)³² Specifically, the Commission finds that the trading of Tech 35 Index options, including full-value and reduced-value Index LEAPS, 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 various high technology industries.³³

The trading of options on the Tech 35 Index and on a reduced-value Index, however, raises several issues relating to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the Amex adequately has addressed these issues.

A. Index Design and Structure

The Commission believes it is appropriate for the Exchange to designate the Index as a narrow-based index for purposes of index options trading. The Index is comprised of a limited number (35) of stocks intended to track a limited range of the technology sector of the stock market. Accordingly, the Commission believes it is appropriate for the Amex to apply its rules governing narrow-based index options to trading in the Index options.³⁴

The Commission also believes that the large capitalizations, liquid markets, and relative weightings of the Index's component stocks significantly

minimize the potential for manipulation of the Index. First, the stocks that comprise the Index are actively traded, with a mean and median average monthly trading volume for the period between December 1, 1994, and May 31, 1995, of 24.1 million and 14.4 million shares, respectively. Second, the market capitalizations of the stocks in the Index are very large, ranging from a high of \$54.0 billion to a low of \$1.1 billion as of June 15, 1995, with the mean and median being \$11.0 billion and \$5.2 billion, respectively. Third, because the index is equal dollar-weighted, no one particular stock or group of stocks dominates the Index. Specifically, as of July 15, 1995, no one stock accounted for more than 3.98% of the Index's total value and the percentage weighting of the five highest weighted stocks in the Index accounted for 18.25% of the Index's value. Fourth, the Index will be maintained so that in addition to the other maintenance criteria discussed above, at each quarterly review and rebalancing (annual or otherwise), at least 90% of the weight of the Index will be composed of securities eligible for standardized options trading.³⁵ Currently, all of the component stocks in the Index have standardized options trading on them. Fifth, Morgan Stanley and the Amex will be required to ensure that each component of the Index is subject to last sale reporting requirements in the U.S. pursuant to Rule 11Aa3-1 of the Act. This will further reduce the potential for manipulation of the value of the Index. Finally, the Commission believes that the existing mechanisms to monitor trading activity in the component stocks of the Index, or options on those stocks, will help deter as well as detect any illegal activity.

In addition, even though the Index is only scheduled to be rebalanced annually, the Commission believes that the Amex and Morgan Stanley have developed several composition and maintenance criteria for the Index that will minimize the possibility that the Index could be manipulated through trading in less actively traded securities or securities with smaller prices or floats. First, if at any time during the year the top five components in the Index, by weight, account for more than one-third of the weight of the Index, the Exchange will rebalance the Index following the close of trading on Expiration Friday in the next month in the March cycle. These rebalancing requirements will serve to ensure that

any "overweight" stock³⁶ will be brought back into line with the other stocks, thus ensuring that less capitalized stocks do not become excessively weighted in the Index.

Second, after each quarterly review and each rebalancing (annual or otherwise), at least 90% of the weight of the Index will be comprised of stocks that are eligible for standardized options trading. The Commission believes that this requirement will ensure that the Index will be almost entirely made up of stocks with large public floats that are actively traded, thus reducing the likelihood that the Index could be easily manipulated by abusive trading in the smaller stocks contained in the Index.

Third, at each quarterly review of the Index, a component may only remain in the Index if it satisfies the maintenance requirements discussed above.³⁷ These requirements are similar to the continued listing requirements for options on individual equity securities.³⁸

Fourth, because the Index is narrow-based, the applicable position and exercise limits (currently 10,500) and margin requirements will further reduce the susceptibility of the Index to manipulation. Lastly, Morgan Stanley will only add stocks to a Replacement List that are representative of the high technology sector and, as discussed above,³⁹ satisfy the inclusion criteria.

The Commission notes that certain concerns are raised when a broker-dealer, such as Morgan Stanley, is involved in the development and maintenance of a stock index that underlies an exchange-traded derivative product. For several reasons, however, the Commission believes that the Amex has adequately addressed this concern with respect to options on the Index.

First, the value of the Index is to be calculated and disseminated by the Amex so that unless a party independently calculates the Index value, neither Morgan Stanley nor any other party will be in receipt of the values prior to the public dissemination of the Index value. Second, routine corporate actions (e.g., stock splits, routine spinoffs, etc.) will be handled by the Amex without consultation with Morgan Stanley. Third, although stock

³⁶ A stock would be "overweight" if its weight in the Index were greater than the average weight of all of the stocks in the Index. This would occur, for example, if the price of a component stock significantly increased relative to the other stocks in the Index during a particular quarter and prior to the rebalancing.

³⁷ See *supra* Section II.E (Maintenance of the Index).

³⁸ See Amex Rule 916.

³⁹ See *supra* Section II.C (Eligibility Standards for the Inclusion of Component Stocks in the Index).

³² 15 U.S.C. 78f(b)(5) (1988).

³³ 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 instruments 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 high technology sector in the U.S. stock markets.

³⁴ See *supra* Section II.I (Position and Exercise Limits, Margin Requirements, and Trading Halts).

³⁵ See Amendment No. 1, *supra* note 4.