IV. 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 15A(b)(6).15 Specifically, the Commission finds that the NASD's proposal to establish uniform listing standards for broadbased stock index warrants, as well as standards applicable to the trading of stock index, currency and currency index warrants by NASD members (or customers thereof) who are not members of the exchange on which the warrant is listed or traded, strikes a reasonable balance between the Commission's mandates under Section 15A(b)(6) to remove impediments to and perfect the mechanism of a free and open market and a national market system, while protecting investors and the public interest. In addition, the NASD's proposed listing standards for warrants are consistent with the Section 15A(b)(6) requirements that rules of a registered securities association be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, and are not designed to permit unfair discrimination among issuers.

The NASD's proposed generic listing standards for broadbased stock index warrants set forth a regulatory framework for the listing of such products. 16 Generally, lifting standards serve as a means for an exchange or securities association to screen issuers and to provide listed status only to bona fide issuances that will have sufficient public float, investor base, and trading interest to ensure that the market has the depth and liquidity necessary to maintain fair and orderly markets. Adequate standards are especially important for warrant issuances given the leveraged and contingent liability they represent. Once a security has been approved for initial listing, maintenance criteria allow an exchange or securities association to monitor the status and trading characteristics of that issue to ensure that it continues to meet the exchange's or securities association's standards for market depth and liquidity so that fair and orderly markets can be maintained.

In reviewing listing standards for derivative-based products, the Commission also must ensure that the

regulatory requirements provide for adequate trading rules, sales practice requirements, margin requirements, position and exercise limits and surveillance procedures. These rules minimize the potential for manipulation and help to ensure that derivativelypriced products will not have negative market impact. In addition, these standards should address the special risks to customers arising from the derivative products.¹⁷ For the reasons discussed below, the Commission believes the NASD's proposal will provide it with significant flexibility to list stock index warrants on NASDAQ, without compromising the effectiveness of the NASD's listing standards or regulatory program for such products. 18

A. Issuer Listing Standards and Product Design

As a general matter, the Commission believes that the trading of warrants on a stock index permits investors to participate in the price movements of the underlying securities, and allows investors holding positions in some or all of such securities to hedge the risks associated with their portfolios. The Commission further believes that trading warrants on a stock index provides investors with an important trading and hedging mechanism that is designed to reflect accurately the overall movement of the component securities.

Warrants, unlike standardized options, however, do not have a clearing house guarantee but are instead dependent upon the individual credit of the issuer. This heightens the possibility that an exerciser of warrants may not be able to receive full cash settlement upon exercise. This additional credit risk, to some extent, is reduced by the NASD's proposed issuer listing standards that require an issuer to have either: (a) a minimum tangible net worth of \$250

million; or (b) a minimum tangible net worth of \$150 million, provided that the issuer does not have (including as a result of the proposed issuance) issued outstanding warrants where the aggregate original issue price of all such stock index, currency and currency index warrant offerings (or affiliates) that are listed on a national securities exchange or traded through the facilities of NASDAQ is in excess of 25% of the warrant issuer's net worth. Furthermore, financial information regarding the issuers of warrants will be disclosed or incorporated in the prospectus accompanying the offering of the warrants.

The NASD's proposal will provide issuers flexibility by allowing them to utilize either a.m. or p.m. settlement, provided, however, domestic index warrants (i.e., warrants based on indexes for which 25% or more of the index value is represented by securities traded primarily in the U.S.) ("domestic index warrants") are required to utilize a.m. settlement of expiring warrants on valuation date ("valuation date") as well as during the last two business days prior to valuation date. The Commission continues to believe that a.m. settlement significantly improves the ability of the market to alleviate and accommodate large and potentially destabilizing order imbalances associated with the unwinding of index-related positions. Nevertheless, the use of p.m. settlement except on valuation date, and during the last two business days prior to the valuation date, strikes a reasonable balance between ameliorating the price effects associated with expirations of derivative index products and providing issuers with flexibility in designating their products. 19

In this context, the Commission notes that unlike standardized index options whose settlement times are relatively uniform, index warrants are issuerbased products, whose terms are individually set by the issuer. In addition, while options may have unlimited open interest, the number of warrants on a given index is fixed at the time of issuance. Accordingly, it is not certain that there will be a significant number or warrants in indexes with similar components expiring on the same day. This may reduce the pressure from liquidation of warrant hedges at settlement. Nevertheless, the Commission expects the NASD to monitor this issue and, should significant market effects occur as a result of early exercises from p.m. settled index warrants, would expect it

^{15 15} U.S.C. 78o-3(b)(6) (1988).

¹⁶ The Commission notes that warrants issued prior to this approval order will continue to be governed by the rules applicable to them at the time of their listing.

¹⁷ Pursuant to Section 6(b)(5) of the Act, the Commission is required to find, among other things, that trading in warrants will serve to protect investors and contribute to the maintenance of fair and orderly markets. In this regard, the Commission must predicate approval of any new derivative product upon a finding that the introduction of such 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. As discussed below, the Commission believes warrants will serve an economic purpose by providing an alternative product that will allow investors to participate in the price movements of the underlying securities in addition to allowing investors holding positions in some or all of such securities to hedge the risks associated with their portfolios.

¹⁸ See supra note 11.

¹⁹ Foreign stock market based index warrants may utilize p.m. settlement throughout their duration.