to make appropriate changes including potentially limiting the number of index warrants with p.m. settlement.

## B. Customer Protection

Due to their derivative and leveraged nature, and the fact that they are a wasting asset, many of the risks of trading in warrants are similar to the risks of trading standardized options. Accordingly, the NASD has proposed to apply its options customer protection rules to warrants. In particular, the Commission notes that warrants may only be sold to options approved accounts capable of evaluating and bearing the risks associated with trading in these instruments, and that adequate disclosure of the risks of these products must be made to investors.20 In addition, the NASD will apply the options rules for suitability, discretionary accounts, supervision of accounts and customer complaints to transactions in warrants. By imposing the special suitability and disclosure requirements noted above, the Commission believes the NASD has addressed adequately several of the potential customer protection concerns that could arise from the options-like nature of warrants.

The ODD, which all options approved accounts must receive, generally explains the characteristics and risks of standardized options products. Although many of the risks to the holder of an index warrant and option are substantially similar, however, because warrants are issuer-based products, some of the risks, such as the lack of a clearinghouse guarantee and certain terms for index warrants, are different. The NASD has adequately addressed this issue by proposing to distribute a circular to its members that will call attention to the specific risks associated with stock index warrants that should be highlighted to potential investors. In addition, the issuer listing guidelines described above will ensure that only substantial companies capable of meeting their warrant obligations will be eligible to issue warrants. These requirements will help to address, to a certain extent, the lack of a clearinghouse guarantee for index warrants. Finally, warrant purchasers will receive a prospectus during the prospectus delivery period, which should ensure that certain information about the participating issuance and issuer is publicly available. The Commission believes that the combined

approach of making available general derivative product information (the ODD), product specific information (the NASD circular), and issuer specific information (the prospectus) should provide an effective disclosure mechanism for these products.

## C. Surveillance

In evaluating proposed rule changes to list derivative instruments, the Commission considers the degree to which the market listing the derivative product has the ability to conduct adequate surveillance. In this regard, the Commission notes that the NASD has developed adequate surveillance procedures for the trading of index and currency warrants. First, the NASD has developed enhanced surveillance procedures to apply to domestic stock index warrants which the Commission believes are adequate to surveil for manipulation and other abuses involving the warrant market and component securities.<sup>21</sup> Among these enhanced surveillance procedures, the Commission notes that issuers will be required to report to the NASD on settlement date the number and value of domestic index warrants subject to early exercise the previous day. The Commission believes that this information will aid the NASD in its surveillance capacity and help it to detect and deter market manipulation and other trading abuses.

Second, the NASD has developed adequate surveillance procedures to apply to foreign stock index warrants (*i.e.*, less than 25% of the index value is derived from stocks traded primarily in the U.S.).<sup>22</sup> The Commission believes that the ability to obtain information regarding trading in the stocks underlying an index warrant is important to detect and deter market manipulation and other trading abuses. Accordingly, the Commission generally requires that there be a surveillance sharing agreement <sup>23</sup> in place between

an exchange listing or trading a derivative product and the exchange(s) trading the stocks underlying the derivative contract that specifically enables the relevant markets to surveil trading in the derivative product and its underlying stocks.<sup>24</sup> Such agreements provide a necessary deterrent to manipulation because they facilitate the availability of information needed to fully investigate a potential manipulation if it were to occur.<sup>25</sup> In this regard, the NASD will require that no more than 20% of an Index's weight may be comprised (upon issuance and thereafter) of foreign securities (or ADRs thereon) that do not satisfy one of the following tests: (1) The NASD has in place an effective surveillance agreement <sup>26</sup> with the primary exchange in the home country in which the security underlying the ADR is traded; or (2) meets an existing alternative standard available for standardized options trading (e.g., satisfy the 50% U.S. trading volume test).<sup>27</sup> The Commission believes that this standard will ensure that index warrants are not listed upon foreign indexes whose underlying securities trade on exchanges with whom the NASD has no surveillance sharing agreement.

## D. Market Impact

The Commission believes that the listing and trading of index warrants will not adversely affect the U.S. securities markets. First, with respect to index warrants, the Commission notes that warrants may only be established upon indexes the Commission has previously approved as broad-based in the context of index options or warrant

<sup>&</sup>lt;sup>20</sup> Pursuant to Article III, Section 33(b)(16) of the Rules of Fair Practice, all options approved accounts must receive an ODD, which discusses the characteristics and risks of standardized options.

<sup>&</sup>lt;sup>21</sup>In addition, the Commission notes that issuers will be required to report to the NASD certain trades (as specified in the NASD's surveillance procedures) to unwind a warrant hedge that are effected as a result of the early exercise of domestic index warrants. This will enable the NASD to monitor the unwinding activity to determine if it was effected in a manner that violates NASD or Commission rules.

<sup>&</sup>lt;sup>22</sup> Each prior issuance of a foreign stock market based index warrant is subject to specific surveillance procedures. These procedures are generally tailored to the individual warrant issuance and are based upon several factors involving the primary foreign market, including the existence of surveillance or information sharing agreements.

<sup>&</sup>lt;sup>23</sup>The Commission believes that a surveillance sharing agreement should provide the parties with the ability to obtain information necessary to detect

and deter market manipulation and other trading abuses. Consequently, the Commission generally requires that a surveillance sharing agreement require that the parties to the agreement provide each other, upon request, information about market trading activity, clearing activity, and the identity of the purchasers for securities. See e.g., Securities Exchange Act Release No. 31529 (Nov. 27, 1992).

<sup>&</sup>lt;sup>24</sup>The ability to obtain relevant surveillance information, including, among other things, the identity of the purchasers and sellers of securities, is an essential and necessary component of a comprehensive surveillance sharing agreement.

<sup>&</sup>lt;sup>25</sup>In the context of domestic index warrants, the Commission notes that the U.S. exchanges and the NASD are members of the Intermarket Surveillance Group ('ISG''), which was formed 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 the amendments made thereafter, was signed by ISG members on January 29, 1990. *See* Second Amendment to the ISG Agreement.

<sup>&</sup>lt;sup>26</sup> See supra note 23.

<sup>&</sup>lt;sup>27</sup> See Securities Exchange Act Release Nos. 31529, 57 FR 57248 (Dec. 3, 1992) and 33555, 59 FR 5619 (Feb. 7, 1994).