

section 15A(b)(6) of the Act<sup>15</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.<sup>16</sup> The Commission believes that the Notes will provide investors with a means to participate in any percentage increase in the Index that exist at the maturity of the Notes, subject to the Capped Value. Specifically, as described more fully above, if the value of the S&P 500 Index has increased, a beneficial owner will be entitled to receive at maturity a payment of the Notes based on triple the amount of any percentage increase in the S&P 500 Index, not to exceed the Capped Value.

The Notes are leveraged debts instruments whose price will be derived from and based upon the value of the Index. In addition, as discussed more fully above, the Notes do not guarantee any return of principal at maturity. Thus, if the S&P 500 Index has declined at maturity, a beneficial owner may receive significantly less than the original public offering price of the Notes.<sup>17</sup> Accordingly, the level of risk involved in the purchase or sale of the Notes is similar to the risk involved in the purchase or sale of traditional common stock. Because the final rate of return on the Notes is derivatively priced and based upon the performance of an index of securities, because the Notes are debt instruments that do not guarantee a return of principal, and because investors' potential return is limited by the Capped Value, there are several issues regarding trading of this type of product. For the reasons discussed below, the Commission believes that Nasdaq's proposal adequately addresses the concerns raised by this type of product.

First, the Commission notes that the protections of NASD Rule 4420(f) were designed to address the concerns attendant to the trading of hybrid securities like the Notes.<sup>18</sup> In particular, by imposing the hybrid listing standards, heightened suitability for

recommendations,<sup>19</sup> and compliance requirements, noted above, the Commission believes that Nasdaq has adequately addressed the potential problems that could arise from the hybrid nature of the Notes. The Commission notes that Nasdaq will distribute a circular to its membership that provides guidance regarding member firm compliance responsibilities and requirements, including suitability recommendations, and highlights the special risks and characteristics associated with the Notes. Specifically, among other things, the circular will indicate that the Notes do not guarantee any return of principal at maturity, that the maximum return on the Notes is limited to \$11.60 and \$16 per unit,<sup>20</sup> that the Notes will not pay interest, and that the Notes will provide exposure in the Index. Distribution of the circular should help to ensure that only customers with an understanding of the risks attendant to the trading of the Notes and who are able to bear the financial risks associated with transactions in the Notes will trade the Notes. In addition, the Commission notes that Merrill Lynch will deliver a prospectus in connection with the initial purchase of the Notes.

Second, the Commission notes that the final rate of return on the Notes depends, in part, upon the individual credit of the issuer, Merrill Lynch. To some extent this credit risk is minimized by the NASD's listing standards in NASD Rule 4420(f), which provide that only issuers satisfying substantial asset and equity requirements may issue these types of hybrid securities. In addition, the NASD's hybrid listing standards further require that the Notes have at least \$4 million in market value. Financial information regarding Merrill Lynch, in addition to information concerning the issuers of the securities comprising the S&P 500 Index, will be publicly available.<sup>21</sup>

Third, the Notes will be registered under section 12 of the Act. As noted above, the NASD's and Nasdaq's existing equity trading rules will apply to the Notes, which will be subject to equity margin rules and will trade during the regular equity trading hours of 9:30 a.m. to 4 p.m. NASD

Regulation's surveillance procedures for the Notes will be the same as its current surveillance procedures for equity securities, and will include additional monitoring on key pricing dates.

Fourth, the Commission has a systemic concern that a broker-dealer, such as Merrill Lynch, or a subsidiary providing a hedge for the issuer will incur position exposure. However, as the Commission has concluded in previous approval orders for the hybrid instruments issued by broker-dealers,<sup>22</sup> the Commission believes that this concern is minimal given the size of the Notes issuance in relation to the net worth of Merrill Lynch.

Finally, the Commission believes that the listing and trading of the proposed Notes should not unduly impact the market for the securities underlying the Index or raise manipulative concerns. In approving the product, the Commission recognizes that the S&P 500 Index is a capitalization-weighted index of 500 companies listed on Nasdaq, the NYSE and the AMEX. The Commission notes that the Index is determined, composed, and calculated by Standard & Poor's. As of January 31, 2003, the aggregate market value of the 500 companies included in the Index represented approximately 79% of the aggregate market value of stocks included in the Standard & Poor's Stock Guidance Database of domestic common stocks traded in the U.S., excluding American depositary receipts, limited partnerships and mutual funds. Standard & Poor's chooses companies for inclusion in the Index with the aim of achieving a distribution by broad industry groupings that approximates the distribution of these groupings in the common stock population of the Standard & Poor's Stock Guide Database. Furthermore, as of February 18, 2003, ten main groups of companies comprise the Index with the percentage weight of the companies included in each group indicated in parentheses as follows: Consumer Discretionary (13.4%), Consumer Staples (9.4%),

<sup>15</sup> 15 U.S.C. 78o-3(b)(6).

<sup>16</sup> In approving the proposed rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>17</sup> Any amount the beneficial owner would receive at maturity (which is less than the original offering price) would correspond to any decline in value of the S&P 500. Telephone conversation between John D. Nachmann, Senior Attorney, Nasdaq, and Florence E. Harmon, Senior Special Counsel, Division of Market Regulation ("Division"), Commission, on March 7, 2003.

<sup>18</sup> See 1993 Order, *supra* note 4.

<sup>19</sup> As discussed above, Nasdaq will advise members recommending a transaction in the Notes to: (1) Determine that the transaction is suitable for the customer; and (2) have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, the transaction.

<sup>20</sup> The actual Capped Value will be determined at the time of issuance of the Notes.

<sup>21</sup> The companies comprising the Index are reporting companies under the Act.

<sup>22</sup> See, e.g., Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving File No. SR-NASD-2001-73) (approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Index); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving File No. SR-Amex-2001-40) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving File No. SR-Amex-96-27) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a weighted portfolio of healthcare/biotechnology industry securities).