

Exchange traded options.⁹ Thus, the only “derivative products”¹⁰ currently subject to stabilization requirements on the Amex are Portfolio Depository Receipts, Index Fund Shares and Trust Issued Receipts (collectively “Exchange Traded Funds” or “ETFs”). The Exchange, accordingly, is proposing to eliminate stabilization rules and other technical requirements of Rule 170 related to stabilization requirements with respect to ETFs.

The Exchange believes that eliminating stabilization rules with respect to ETFs is appropriate in view of the fact that ETFs, like options, are priced derivatively, based upon the value of an underlying basket of securities. Thus, the Exchange believes that there should be no concern that specialist ETF transactions would “lead the market” with respect to the price of an ETF if he or she effected purchases of plus or zero-plus ticks, or effected sales on minus or zero-minus ticks.

In this regard, the Exchange notes that the Commission has, in many instances, granted “no action” relief for short sales of ETFs with respect to the Commission’s “Short Sale Rule” (Rule 10a-1 under the Act) in large part due to the derivative pricing of ETFs.¹¹ The Exchange also notes that the Commission recently approved an Amex rule change that allowed side-by-side trading of broad based ETFs and the related options as a result of the

derivative pricing of ETFs.¹² In both situations, according to the Exchange, the Commission discounted the possibility of inappropriate activity by ETF specialists due to the derivative pricing of these securities. The Exchange also believes that requiring a Floor Official to review a proposed transaction on a destabilizing “tick” prior to execution is contrary to the interests of investors in the context of derivatively priced ETFs since the delay caused by Floor Official review may cause customers to receive an inferior execution or miss the market.

The Exchange believes that ETFs should not be subject to the maximum quote spread rules applicable to options.¹³ These rules were adopted on the Amex in 1974 and originally applied to registered option traders. In 1989, the option quote spread rules were formally extended to Amex specialists.¹⁴ During the period between 1974 and 1989, the Commission restricted the trading of listed options on more than one exchange, and the Commission did not completely eliminate these restrictions until December 31, 1994.¹⁵ Currently, all option exchanges have similar maximum quote spread rules.¹⁶

The Exchange believes that extending maximum quote spread rules to ETFs may have an anti-competitive impact by establishing a regulatory requirement on the Amex that does not exist in the other market centers that trade ETFs. Unlike the situation with listed options where all option exchanges have similar rules regulating bid/ask differentials, the Exchange believes that none of the registered exchanges, ATSS, third market dealers, or Nasdaq that currently trade ETFs establish, or are subject to, maximum quote spread differentials. The Exchange also believes that extending maximum quote spreads rules to ETFs would serve no investor protection purpose since trading in ETFs is characterized by vigorous competition among market centers. If investors are unsatisfied with the quote for an ETF displayed in a particular

market center, the Exchange believes that they can trade the security in another market. Competition among market centers, not quote spread regulation, maintains ETF bid/ask differentials at appropriate levels.

The Exchange is proposing to exempt ETFs from the other technical requirements of Rule 170 from which options were exempted in 1989.¹⁷ These sections deal with transactions which: (1) May be subject to the Commission’s short sale rule (Commentary .06); and (2) are assigned to investment accounts (Commentary .07). The Exchange believes that eliminating Commentary .06 with respect to ETFs is appropriate because this Commentary simply reminds specialists that they are subject to the Commission’s short sale rule. Since the short sale rule frequently does not apply to ETFs due to the Commission’s provision of “no action” relief, the Commentary creates an ambiguity regarding the applicability of the short sale rule to specialist transactions in ETFs. The Exchange, accordingly, is proposing to eliminate Commentary .06 with respect to ETFs to the extent that the Commission has granted no action relief or has otherwise exempted the securities from the short sale rule. Commentary .07 restricts the ability of specialists to assign securities to an investment account unless the securities were acquired in transactions that meet certain rigorous stabilization tests. Since the prices of ETF trades are determined derivatively, it is impossible for specialists to satisfy the stabilization tests of Commentary .07 and they cannot, consequently, establish investment accounts for these securities. The Exchange, accordingly, is proposing to eliminate Commentary .07 with respect to ETFs.

The Exchange also is proposing to correct erroneous cross references in Rules 1000(a) and 1000A(a) to the definitions of the terms “derivative products” and “security or securities” in the Exchange Constitution.

2. Statutory Basis

As described above, the proposed rule change is consistent with Section 6(b) of the Act¹⁸ in general and furthers the objectives of Section 6(b) of the Act¹⁹ in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in

⁹ See Securities Exchange Act Release No. 27235 (September 11, 1989), 54 FR 38580 (September 19, 1989).

¹⁰ Article 1, Section 3(d) of the Exchange Constitution defines “derivative products” as follows:

The term “derivative products” includes, in addition to standardized options, other securities which are issued by The Options Clearing Corporation or another limited purpose entity or trust, and which are based solely on the performance of an index or portfolio of other publicly traded securities. Notwithstanding the foregoing, the term “derivative products” shall not include warrants of any type or closed-end management investment companies.

¹¹ See e.g. Letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to James F. Duffy, Executive Vice President and General Counsel, American Stock Exchange, dated March 3, 1999 (regarding Nasdaq-100 Trust, Series 1). This letter states in part:

On the basis of your representations and the facts presented, in particular the composite and derivative nature of the Nasdaq-100 Shares, trading would not appear to be susceptible to the practices that Rule 10a-1 is designed to prevent. In particular, the Amex anticipates that the market value of the Nasdaq-100 Shares will rise or fall based on changes in the net asset value of the Trust. Moreover, the short sale rule does not apply to analogous derivative products such as index options and index futures contracts. Accordingly, the Commission hereby grants an exemption to Rule 10a-1 to permit sales of Nasdaq-100 Shares without regard to the ‘tick’ requirements of Rule 10a-1.

¹² See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002).

¹³ See Commentary .01 to Amex Rule 950(n) and Amex Rule 958(c).

¹⁴ The Exchange adopted the maximum quote spread rules applicable to registered options traders in 1975 and formally extended them to options specialists in 1989. See Securities Exchange Act Release No. 27235 (September 11, 1989), 54 FR 38580 (September 19, 1989).

¹⁵ See Discussion on the history of restrictions on the multiple listing of options in *In Re: Stock Exchanges Options Trading Antitrust Litigation*, 171 F.Supp. 2d 1974 (April 24, 2001).

¹⁶ See Chicago Board Options Exchange, Inc. Rule 8.7, Pacific Stock Exchange, Inc. Rule 6.37, Philadelphia Stock Exchange, Inc. Rule 1014, and International Stock Exchange Rule 803.

¹⁷ See *supra* note 9.

¹⁸ 15 U.S.C. 78f(b).

¹⁹ 15 U.S.C. 78f(b)(5).