

finds that the proposed rule change, as amended, is consistent with section 6(b)(5) of the Act<sup>13</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest. In addition, the Commission finds that the proposed rule change, as amended, is consistent with sections 6(b)(1) and 6(b)(7) of the Act<sup>14</sup> in that it requires compliance by the Exchange members and persons associated with its members with the Act, the rules and regulations thereunder, and Exchange rules; and provides a fair procedure for the disciplining of Exchange members.

The Commission believes that the proposed rule change, as amended, should limit ex parte communications in the disciplinary process, thereby providing a safeguard against influence over the outcome of a disciplinary proceeding and eliminating the appearance of unfairness. The Commission notes that the Exchange currently prohibits ex parte communications between persons involved in disciplinary proceedings and the Exchange's BCC. Extending the prohibition to Board members is consistent with practices on other SROs.<sup>15</sup>

The Commission believes that proposed Interpretations .02 and .03 to the proposed rule change should provide objective criteria and guidance regarding the application of the proposed rule change, as amended. The Commission notes that proposed Interpretation .02 excludes from the prohibition against ex parte communications any ex parte communications dealing solely with procedural matters. The Commission further notes that the Exchange has provided examples of what it considers "solely procedural matters." The Commission believes that proposed Interpretation .03 strikes the right balance permitting persons who refuse an attempted ex parte communication to avoid violating the rule, provided that they report such attempted communication and their responses to such communications to Exchange regulatory staff. The proposed Interpretation would also require Exchange regulatory staff to keep a record of the attempted ex parte communication in the regulatory record

of the investigation or disciplinary proceeding. In addition, the Commission notes that the Exchange has represented that it will give copies of the attempted ex parte communication to all of the parties involved in the proceeding.<sup>16</sup>

Furthermore, the Commission believes that allowing the Exchange's OOE to appeal a decision of the BCC to the Board regarding factual findings that the OOE believes may have been in error or disciplinary sanctions that it finds insufficient, is consistent with practices on other SROs.<sup>17</sup>

In addition, the Commission finds good cause for approving Amendment Nos. 2 and 3 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 2 deletes proposed CBOE Rule 17.15 and amends CBOE Rule 17.4 to incorporate the Board into the prohibition against ex parte communications with the BCC. The Commission believes this change is not substantively different from the proposal, as published. In addition, it makes sense for the Board to be subject to the same limitations that the BCC is subject to. As discussed more fully above, Amendment No. 3 provides clarity to proposed rule change by requiring persons to report attempted communications, and by requiring Exchange regulatory staff to memorialize the communications. In addition, Amendment No. 3 provides examples of what the Exchange would consider "solely procedural matters" for purposes of proposed Interpretation .02. The Commission, therefore, finds good cause to approve Amendment Nos. 2 and 3 to the proposed rule change on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 2 and 3, including whether the Amendment Nos. 2 and 3 to the proposed rule change are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the

Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CBOE-2001-59 and should be submitted by January 7, 2003.

#### V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (SR-CBOE-2001-59) and Amendment No. 1 are hereby approved, and that Amendment Nos. 2 and 3 to the proposed rule change are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

[FR Doc. 02-31653 Filed 12-16-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46975; File No. SR-CME-2002-02]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change by the Chicago Mercantile Exchange Relating to Listing Standards for Security Futures Products

December 9, 2002.

Pursuant to Section 19(b)(7) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-7 under the Act,<sup>2</sup> notice is hereby given that on October 28, 2002, Chicago Mercantile Exchange ("CME" or "the Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by CME.

On November 1, 2002, CME filed an amendment to the proposed rule change to clarify the proposed rules.<sup>3</sup> On

<sup>18</sup> 15 U.S.C. 78s(b)(2).

<sup>19</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(7).

<sup>2</sup> 17 CFR 240.19b-7.

<sup>3</sup> See letter from Richard J. McDonald, Managing Director, Product Development, CME, to Office of Market Supervision, Division of Market Regulation,

impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> 15 U.S.C. 78f(b)(1); and 15 U.S.C. 78f(b)(7).

<sup>15</sup> See, e.g., supra note 7.

<sup>16</sup> Telephone conversation between Christopher R. Hill, Attorney II, Office of Enforcement, Legal Division, CBOE, and Kathy A. England, Assistant Director, and Sapna C. Patel, Attorney, Division, Commission, on December 5, 2002.

<sup>17</sup> See, e.g., supra note 11.

November 6, 2002, CME filed an amendment to the proposed rule change to reflect technical changes to the proposed rules.<sup>4</sup> On November 20, 2002, CME filed an amendment to the proposed rule change to provide additional information for inclusion in this Notice, and to reflect further technical changes to the proposed rules.<sup>5</sup>

The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. CME also has certified the proposed rule change with the Commodity Futures Trading Commission ("CFTC") under Section 5c(c) of the Commodity Exchange Act<sup>6</sup> on October 28, 2002.

### I. Self-Regulatory Organization's Description of the Proposed Rule Change

CME proposes to adopt Security Futures Product Listing Standards ("CME Listing Standards") for purposes of Section 6(h) of the Act.<sup>7</sup> The CME Listing Standards are generally identical to the sample listing standards (the "Sample Listing Standards") published in Staff Legal Bulletin No. 15 ("SLB 15")<sup>8</sup> except that they:

- Reflect the modifications to the statutory listing standards requirements adopted by the Commission and the CFTC governing shares of American Depositary Receipts, exchange-traded funds, trust-issued receipts and shares of registered closed-end management investment companies;<sup>9</sup> and
- Establish an approximately equal dollar weighting methodology for physically settled futures based on narrow-based security indices ("NBIs") which (1) requires the number of each component security to be rounded up or

down to the nearest multiple of 100 shares or receipts in the course of the initial index composition and any subsequent rebalancing, (2) contemplates mandatory annual rebalancing of such indices under specified circumstances, complemented by CME's ability to rebalance indices on an interim basis if it so elects; and (3) ensures that outstanding contracts will not be affected by any rebalancing.

### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

CME has prepared statements concerning the purpose of, and basis for, the proposed rule change, burdens on competition, and comments received from members, participants, and others. The text of these statements may be examined at the places specified in Item IV below. These statements are set forth in Sections A, B, and C below.

#### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

##### 1. Purpose

Section 6(h)(3) of the Act<sup>10</sup> identifies requirements for listing standards applicable to security futures products. In particular, the Act requires that such listing standards: (1) Must be no less restrictive than comparable listing standards for options traded on a national securities exchange; and (2) must require that trading in security futures products not be readily susceptible to manipulation of the price of such products or of the underlying securities or options on such securities.

Listing Standards—The Sample Listing Standards found in SLB 15 were modeled after listing standards employed by option exchanges and were intended to provide guidance as to how the requirements under the Act may be addressed but also provided that alternate standards could be consistent with the Act as well.

Accordingly, the CME Listing Standards are generally modeled on the Sample Listing Standards (as modified by the Commissions' orders regarding American Depositary Receipts, exchange-traded funds, trust-issued receipts and registered closed-end management investment companies<sup>11</sup> and subject to additional modifications relating to physically settled futures based on NBIs described above. These additional modifications are (1) limited in application to physically settled

contracts, and (2) designed to enhance the utility of NBI futures in connection with hedging, arbitrage and other investment applications.

CME contemplates the possibility that it may seek to list physically settled NBI futures per its belief that physical settlement might reduce basis risk and result in tighter bid/offer spreads, limiting the potential for market manipulation, under certain circumstances where the NBI is comprised of a very limited number of securities.

CME believes that it is impracticable to make delivery of securities in lot sizes smaller than the customary transactional unit of 100 shares or receipts. Thus, rounding is required with respect to the initial composition and subsequent rebalancing of physically settled futures based on NBIs. If the composition of NBIs were subject to frequent or retroactive changes as a result of index rebalancings, NBI futures would lose their potential as particularly effective tools in the implementation of hedging, arbitrage and other investment applications.

The Sample Listing Standards contemplate at least quarterly rebalancings of equal dollar-weighted indices. The CME Listing Standards modify this requirement by providing that an approximately equal dollar-weighted NBI underlying a physically settled security futures product is to be rebalanced annually, but only if the aggregate value of the security position with the highest value is two or more times greater than the aggregate value of the security position with the lowest value in the index for a specified time period. CME believes that this procedure effectively balances the potential adverse consequences of frequent composition adjustments with concerns regarding the degree to which an NBI represents the subject industry sector.

CME may rebalance NBIs on an interim basis if warranted as a result of extraordinary changes in the relative values of the component securities. To the extent investors with open positions must rely upon the continuity of the futures contract, CME Listing Standards clarify that outstanding contracts are unaffected by rebalancings. Precedent for these provisions may be found in the rules of the American Stock Exchange ("Amex") for portfolio depository receipts<sup>12</sup> and index fund shares<sup>13</sup>

Commission, dated October 31, 2002 ("Amendment No. 1").

<sup>4</sup> See letter from Richard J. McDonald, Managing Director, Product Development, CME, to Office of Market Supervision, Division of Market Regulation, Commission, dated November 5, 2002 ("Amendment No. 2").

<sup>5</sup> See letter from Richard J. McDonald, Managing Director, Product Development, CME, to Office of Market Supervision, Division of Market Regulation, Commission, dated November 19, 2002 ("Amendment No. 3").

<sup>6</sup> 7 U.S.C. 7a-2(c).

<sup>7</sup> 15 U.S.C. 78f(h).

<sup>8</sup> SEC Division of Market Regulation: Staff Legal Bulletin No. 15: Listing Standards for Trading Security Futures Products (September 5, 2001).

<sup>9</sup> See Joint Order Granting the Modification of Listing Standards Requirements (American Depositary Receipts), Securities Exchange Act Release No. 44725 (August 20, 2001) and Joint Order Granting the Modification of Listing Standards Requirements (Exchange Traded Funds, Trust Issued Receipts and shares of Closed-End Funds), Securities Exchange Act Release No. 46090 (June 19, 2002), 67 FR 42760 (June 25, 2002).

<sup>10</sup> 15 U.S.C. 78f(h)(3)(I).

<sup>11</sup> See *supra*, n. 9.

<sup>12</sup> See Amex Rule 1000, in particular Commentary .03 thereto.

<sup>13</sup> See Amex Rule 1000A, in particular Commentary .02 thereto.

which provide for a “modified equal-dollar weighting” and do not appear to provide for rebalancing. Rebalancing is likewise not required in the context of trust-issued receipts traded on Amex.<sup>14</sup>

The contents of the CME Listing Standards, including the approximately equal dollar-weighting methodology described above, will be publicly available and fully disclosed.

**Section 6(h)(3) Requirements—**Section 6(h)(3) of the Act<sup>15</sup> contains detailed requirements for listing standards and conditions for trading applicable to security futures products. Set forth below is a summary of each such requirement or condition, followed by a brief explanation of how CME will comply with it, whether by particular provisions in the CME Listing Standards or otherwise.

Clause (A) of Section 6(h)(3)<sup>16</sup> requires that any security underlying a security future be registered pursuant to Section 12 of the Act.<sup>17</sup> This requirement is addressed by CME Rules 70001.2, 70003.2.b. and 70004.2.a.

Clause (B) of Section 6(h)(3)<sup>18</sup> requires that a market on which a physically settled security futures product is traded have arrangements in place with a registered clearing agency for the payment and delivery of the securities underlying the security futures product. CME has reached an agreement with a registered clearing agency to facilitate the payment and delivery of securities underlying security futures products. This agreement will be fully operational prior to any possible delivery event associated with such security futures products.

Clause (C) of Section 6(h)(3)<sup>19</sup> provides that listing standards for security futures products must be no less restrictive than comparable listing standards for options traded on a national securities exchange or national securities association registered pursuant to Section 15A(a) of the Act.<sup>20</sup> For the reasons discussed above, notwithstanding specified differences between the Sample Listing Standards and the CME Listing Standards, CME believes that the latter are no less restrictive than comparable listing standards for exchange-traded options.

Clause (D) of Section 6(h)(3)<sup>21</sup> requires that each security future be

based on common stock or such other equity securities as the Commission and the Commodity Futures Trading Commission jointly determine appropriate. This requirement is addressed by Rules 70001.1, 70003.2.c. and 70004.2.b.

Clause (E) of Section 6(h)(3)<sup>22</sup> requires that each security futures product be cleared by a clearing agency that has in place provisions for linked and coordinated clearing with other clearing agencies that clear security futures products, which permits the security futures product to be purchased on one market and offset on another market that trades such product. CME intends to clear security futures products traded through Exchange facilities through the CME Clearing House Division. The Clearing House Division will have in place all provisions for linked and coordinated clearing as mandated by law and statute as of the effective date of such laws and statutes.

Clause (F) of Section 6(h)(3)<sup>23</sup> requires that only a broker or dealer subject to suitability rules comparable to those of a national securities association registered pursuant to Section 15A(a) of the Act<sup>24</sup> effect transactions in a security futures product.

CME clearing members, and their correspondents, are bound by the applicable sales practice rules of the National Futures Association (“NFA”), which is a national securities association. As such, the sales practice rules of the NFA are, perforce, comparable to those of a national securities association registered pursuant to Section 15A(a) of the Act.<sup>25</sup> The application of NFA sales practice rules is extended beyond the CME clearing membership to the extent that NFA By-Law 1101 provides that “[n]o member may carry an account, accept an order or handle a transaction in commodity futures contracts for or on behalf of any non-Member of NFA.”

Clause (G) of Section 6(h)(3)<sup>26</sup> requires that each security futures product be subject to the prohibition against dual trading in Section 4j of the Commodity Exchange Act<sup>27</sup> and the rules and regulations thereunder or the provisions of Section 11(a) of the Act<sup>28</sup> and the rules and regulations thereunder. Exchange Rule 123 requires Exchange members to comply with all

applicable “provisions of the Commodity Exchange Act and regulations duly issued pursuant thereto by the CFTC.”

Note that the prohibition of dual trading in security futures products per CFTC Regulation § 41.27<sup>29</sup> adopted pursuant to Section 4j(a) of the Commodity Exchange Act<sup>30</sup> applies to a contract market operating an electronic trading system if such market provides participants with a time or place advantage or the ability to override a predetermined matching algorithm. CME anticipates that trading of security futures products on CME will be fully electronic. Further, the Exchange will not provide participants with a time or place advantage or the ability to override a predetermined matching algorithm in the context of security futures products.

Clause (H) of Section 6(h)(3)<sup>31</sup> provides that trading in a security futures product must not be readily susceptible to manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security, option on such security, or option on a group or index including such securities.

CME Listing Standards are designed to ensure that CME products and the underlying securities will not be readily susceptible to price manipulation. Exchange Rule 432 defines activity “to manipulate prices or to attempt to manipulate prices” as a “major offense,” punishable, per Exchange Rule 430, by “expulsion, suspension, and/or a fine of not more than \$1,000,000 plus the monetary value of any benefit received as a result of the violative action.”

Clause (I) of Section 6(h)(3)<sup>32</sup> requires that procedures be in place for coordinated surveillance amongst the market on which a security futures product is traded, any market on which any security underlying the security futures product is traded, and other markets on which any related security is traded to detect manipulation and insider trading.

CME is an affiliate member of the Intermarket Surveillance Group (“ISG”) and is party to an affiliate agreement and an agreement to share market surveillance and regulatory information with the other ISG members. Further, CME is party to a supplemental agreement regarding security futures

<sup>14</sup> See Amex Rule 1202, in particular Commentary .01 thereto.

<sup>15</sup> 15 U.S.C. 78f(h)(3).

<sup>16</sup> 15 U.S.C. 78f(h)(3)(A).

<sup>17</sup> 15 U.S.C. 78l.

<sup>18</sup> 15 U.S.C. 78f(h)(3)(B).

<sup>19</sup> 15 U.S.C. 78f(h)(3)(C).

<sup>20</sup> 15 U.S.C. 78o-3f(a).

<sup>21</sup> 15 U.S.C. 78f(h)(3)(D).

<sup>22</sup> 15 U.S.C. 78f(h)(3)(E).

<sup>23</sup> 15 U.S.C. 78f(h)(3)(F).

<sup>24</sup> 15 U.S.C. 78o-(a).

<sup>25</sup> 15 U.S.C. 78o-(a).

<sup>26</sup> 15 U.S.C. 78f(h)(3)(G).

<sup>27</sup> 7 U.S.C. 6j.

<sup>28</sup> 15 U.S.C. 78k.

<sup>29</sup> 17 CFR 41.27.

<sup>30</sup> 7 U.S.C. 4j(a).

<sup>31</sup> 15 U.S.C. 78f(h)(3)(H).

<sup>32</sup> 15 U.S.C. 78f(h)(3)(I).

with the other ISG members with respect to affiliate ISG membership.<sup>33</sup>

Note that CME Rule 424 permits CME to enter into agreements for the exchange of information and other forms of mutual assistance with domestic or foreign self-regulatory organizations, associations, boards of trade and their respective regulators.

Clause (J) of Section 6(h)(3)<sup>34</sup> requires that a market on which a security futures product is traded have in place audit trails necessary or appropriate to facilitate the coordinated surveillance referred to in the preceding paragraph.

The audit trail capability provided by GLOBEX®, the Exchange's trade matching engine, includes specialized electronic surveillance programs to identify potentially abusive trades and trade patterns. GLOBEX creates and maintain an electronic transaction history database that contains information with respect to all transactions executed on the Exchange. The audit trail capability includes an electronic analysis capability, permitting the sorting and presentation of data included in the transaction history in order to reconstruct trading and to identify possible trading violations with respect to both customer and market abuses.

Information recorded with respect to each order includes: Time entered, terms of the order, order type, instrument and contract month, price, quantity, account type, account designation, user code and clearing firm. This information is archived and maintained by the CME Market Regulation Department.

For orders that cannot be immediately entered into CME's systems and, therefore, will not be recorded electronically at the time they are received, Exchange Rule 536 requires that the complete written records of each order must be prepared and retained. Each such record must be retained for at least five years.

Clause (K) of Section 6(h)(3)<sup>35</sup> requires that a market on which a security futures product is traded have in place procedures to coordinate trading halts between such market and any market on which any security underlying the security futures product is traded and other markets on which any related security is traded.

The Exchange proposes to amend its Rules 71001.E. and 71301.E. to clarify that trading in security futures shall be

halted when a regulatory halt occurs in the underlying security or securities, as defined in CFTC Regulation 41.1(l). The Exchange intends to make such amendment by certification of such amendments with the CFTC per Section 5c(c) of the Commodity Exchange Act and Regulation 41.24 thereunder, with a copy to the SEC.

Clause (L) of Section 6(h)(3)<sup>36</sup> requires that the margin requirements for a security futures product comply with the regulations prescribed pursuant to Section 7(c)(2)(B) of the Act.<sup>37</sup> As set forth in Amendment No. 1 to a Form 19b-4 separately filed by CME with the Commission on October 3, 2002, CME believes that its proposed Rules regarding customer margin are consistent with the requirements of the Act.

For the reasons described above, CME submits that the CME Listing Standards submitted herewith, satisfy the requirements set forth in Section 6(h)(3) of the Act.<sup>38</sup>

## 2. Statutory Basis

The CME Listing Standards are authorized by, and consistent with, Section 6(b)(5)<sup>39</sup> of the Act because they are designed to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade.

### B. Self-Regulatory Organization's Statement on Burden on Competition

CME does not believe that the CME Listing Standards will have an impact on competition because (1) it may be anticipated that other self-regulatory organizations that will list security futures products will adopt substantially similar listing standards; and (2) any concerns about possible anti-competitive effects should be evaluated in light of the standards applicable to other financial instruments based on narrowly based security indices or baskets, which are consistent with the CME Listing Standards.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Comments on the CME Listing Standards have not been solicited.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The proposed rule change has become effective on October 28, 2002, except that the technical changes made in Amendment Nos. 2 and 3 have become effective on November 5 and 19, respectively. Within 60 days of the date of effectiveness of the proposed rule change, the Commission, after consultation with the CFTC, may summarily abrogate the proposed rule change and require that the proposed rule change be refiled in accordance with the provisions of Section 19(b)(1) of the Act.<sup>40</sup>

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change conflicts with the Act. Persons making written submissions should file nine copies of the submission with the Secretary, SEC, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically to the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of these filings also will be available for inspection and copying at the principal office of CME. Electronically submitted comments will be posted on the Commission's Internet website (<http://www.sec.gov>). All submissions should refer to File No. SR-CME-2002-02 and should be submitted by January 7, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>41</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 02-31652 Filed 12-16-02; 8:45 am]

**BILLING CODE 8010-01-U**

<sup>33</sup> See Joint Notice of Final Rules, Release No. 34-45956 (May 17, 2002), 67 FR 36740, 36750-51 (May 24, 2002).

<sup>34</sup> 15 U.S.C. 78f(h)(3)(J).

<sup>35</sup> 15 U.S.C. 78f(h)(3)(K).

<sup>36</sup> 15 U.S.C. 78f(h)(3)(L).

<sup>37</sup> 15 U.S.C. 78g(c)(2)(B).

<sup>38</sup> 15 U.S.C. 78f(h)(3).

<sup>39</sup> 15 U.S.C. 78f(g).

<sup>40</sup> 15 U.S.C. 78s(b)(1).

<sup>41</sup> 17 CFR 200.30-3(a)(75).