

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49548; File No. SR-Amex-2004-02)

April 9, 2004

Self Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Amendment No. 1 by the American Stock Exchange LLC Relating to the Listing and Trading of Notes Linked to the Performance of the Select Utility Index

On January 8, 2004, the American Stock Exchange LLC (“Amex” or “Exchange”), filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to list and trade notes, the return on which is based upon a modified market capitalization-weighted portfolio of 20 dividend paying common stocks selected from the Standard & Poor’s (“S&P”) Utilities Sector, as reconstituted from time to time in the manner set forth in the Amex’s proposal (the “Select Utility Index”). On February 12, 2004, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup>

The proposed rule change was published for comment in the Federal Register on February 23, 2004.<sup>4</sup> The Commission received no comments on the proposal.

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Letter from Jeffrey P. Burns, Associate General Counsel, Amex, to Nancy Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated February 11, 2004 (“Amendment No. 1”). In Amendment No. 1, the Amex clarified its earlier comparison of the Select Utility Index proposed herein with an existing index, the Select Sector Utilities Index. The Amex also included a representation that the Exchange would consult with the Commission in the event that the number of Index components falls to ten (10) or fewer stocks.

<sup>4</sup> See Securities Exchange Act Release No. 49239 (February 12, 2004), 69 FR 8245 (February 23, 2004) (“Notice”).

Based on the description of the Notes, the Select Utility Index methodology, and the listing and trading criteria set forth in the Notice, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>5</sup> and, in particular, the requirements of Section 6 of the Act<sup>6</sup> and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>7</sup> which requires, among other things, that the rules of an exchange be designed to facilitate transactions in securities, 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 general to protect investors and the public interest. The Commission believes that the Amex's proposal to list and trade notes based on the Select Utility Index gives investors exposure to the dividend paying stocks in the S&P Utilities Sector and the ability to make additional unique investment choice in a manner consistent with the requirements of Section 6(b)(5)<sup>8</sup> of the Act.

As described in the Notice, at maturity, the holder of a Note will received an amount based upon the percentage change of the Select Utility Index. The Notes will not have a minimum principal amount that will be repaid and, accordingly, payments on the Notes prior to or at maturity may be less than the original issue price of the Notes. The

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<sup>5</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78f.

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>8</sup> Id.

Notes are cash-settled in U.S. dollars and do not give the holders any right to receive a portfolio security or any other ownership right or interest in the portfolio of securities comprising the Select Utility Index. As described in the Notice, the Select Utility Index is initially constituted and reconstituted in a manner to reduce market impact and provide a better process for the Issuer to hedge its market risk in connection with the Notes.

While the Exchange states that there will be limited change in the component stocks of the Select Utility Index, there may be significant changes in the weightings because the market capitalization weighting is adjusted so that no one component exceeds 10%.

However, the Commission finds that this initial constitution and the quarterly reconstitutions are disclosed, and the process of constitutions and reconstitutions should help to alleviate both market impact and Issuer risk.

Subject to the criteria in the Prospectus for the Notes, the Amex has sole discretion regarding changes to the Select Utility Index due to reconstitutions and adjustments to the Index and the multipliers of the individual components. Thus, the Amex is determining, calculating, and selecting the component stocks of Index based on the 20 highest combined dividends scores on the relevant determination date. Amex represents that it maintains and enforces appropriate policies and trading restrictions that address the use of non-public information by its employees, such as non-public knowledge derived in the component selection and maintenance of the Select Utilities Index.

As of April 8, 2004, the market capitalization of the securities included in the Index ranged from a high of \$22 billion to a low of 1 billion. The average daily trading volume for these same securities for the last six (6) months ranged from a high of

564,568 shares to a low of 124,400 shares.<sup>9</sup> Given that large trading volume and capitalization of the component securities underlying the Index, the Commission believes that the listing and trading of the Notes that are linked to the Select Utility Index should not unduly impact the market for the underlying securities or raise manipulative concerns. Moreover, the issuers of the underlying securities comprising the Select Utility Index, are subject to reporting requirements under the Act, and all of the component stocks are either listing or traded on, or traded through the facilities of, U.S. securities markets. In addition, the Exchange's equity margin and trading rules will apply to the Notes. The Commission also believes that the Exchange has appropriate surveillance procedures in place to detect and deter potential manipulation for similar index-lined products. By applying these procedures to the Notes, the Commission believes that the potential for manipulation of the underlying securities is minimal, thereby protecting investors and the public interest.

Furthermore, the Commission notes that the Notes are dependant upon the individual credit of the issuer, Merrill Lynch. To some extent this credit risk is minimized by the Exchange's listing standards in Section 107A of the Company Guide which provide that only issuers satisfying substantial asset and equity requirements may issue securities such as the Notes. In any event, financial information regarding Merrill

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<sup>9</sup> Telephone Conversation between Jeffrey P. Burns, Associate General Counsel, Amex, and Florence Harmon, Senior Special Counsel, Division, Commission, on April 8, 2004.

Lynch, in addition to the information on the component stocks comprising the Index, will be publicly available.<sup>10</sup>

The Commission also has a systemic concern, however, 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 other hybrid instruments issued by broker-dealers,<sup>11</sup> the Commission believes that this concern is minimal given the size of the Notes issues in relation to the net worth of Merrill Lynch.

Finally, the Commission notes that the value of the Index will be disseminated at least once every fifteen seconds throughout the trading day. The Commission believes that providing access to the value of the Index at least once every fifteen seconds throughout the trading day is extremely important and will provide benefits to investors in the products.

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<sup>10</sup> The Commission notes that the component stocks that comprise the Index are reporting companies under the Act, and the Notes will be registered under Section 12 of the Act.

<sup>11</sup> See Securities Exchange Act Release No. 47983 (June 4, 2003), 68 FR 5032 (June 11, 2003).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (File No. SR-Amex-2004-02), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).