

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51891; File No. SR-NASD-2004-139)

June 21, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to the Listing and Trading of Leveraged Index Return Notes Linked to the Dow Jones Industrial Average

I. Introduction

On September 15, 2004, the National Association of Securities Dealers, Inc. (“NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to list and trade Leveraged Index Return Notes Linked to the Dow Jones Industrial Average (“Notes”) issued by Merrill Lynch & Co., Inc. (“Merrill Lynch”). On March 21, 2005, Nasdaq submitted Amendment No. 1.³ The proposed rule change, as modified by Amendment No. 1, was published for notice and comment in the Federal Register on March 30, 2005.⁴ The Commission received no comment letters regarding the proposed rule change. On May 31, 2005, Nasdaq submitted Amendment No. 2 to the proposal.⁵ This order approves the proposed rule change, as

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, Nasdaq provided additional details regarding the proposed index linked notes and underlying index.

⁴ See Securities Exchange Act Release No. 51425 (March 23, 2005), 70 FR 16322 (“Notice”).

⁵ In Amendment No. 2, Nasdaq modified its proposal to include conditions under which it would commence delisting or removal proceedings with respect to the Notes.

modified by Amendment No. 1. Simultaneously, the Commission provides notice of filing of Amendment No. 2 and grants accelerated approval of Amendment No. 2.

II. Description of Proposal

Nasdaq proposes to list and trade the Notes, which provide for a return based upon the Dow Jones Industrial Average (“Index”). As set forth in the Notice, the Index is a price-weighted index published by Dow Jones & Company, Inc. A component stock’s weight in the Index is based on its price per share, rather than the total market capitalization of the issuer of that component stock. The value of the Index is the sum of the primary market prices of each of the 30 common stocks included in the Index, divided by a divisor that is designed to provide a meaningful continuity in the value of the Index. In order to prevent certain distortions related to extrinsic factors, the divisor may be adjusted appropriately. The current divisor of the Index is published daily in the WSJ and other publications. Other statistics based on the Index may be found in a variety of publicly available sources. The value of the Index is widely disseminated at least every 15 seconds by providers that are independent from Merrill Lynch. In the event the calculation or dissemination of the Index is discontinued, Nasdaq will delist the Notes.

The Index is designed to provide an indication of the composite price performance of 30 common stocks of corporations representing a broad cross-section of U.S. industry. The corporations represented in the Index tend to be market leaders in their respective industries, and their stocks are typically widely held by individuals and institutional investors. The component stocks in the Index are selected (and any changes are made) by the editors of the Wall Street Journal (“WSJ”). Changes to the stocks included in the Index tend to be made infrequently. Historically, most substitutions have been the result of mergers, but from time to time, changes

may be made to achieve what the editors of the WSJ deem to be a more accurate representation of the broad market of the U.S. industry.

As of August 27, 2004, the market capitalization of the securities included in the Index ranged from a high of approximately \$346 billion to a low of approximately \$24 billion. The average daily trading volume for Index components (calculated over the previous thirty trading days) ranged from a high of approximately 24 million shares to a low of approximately 1.7 million shares.

In its proposal, Nasdaq also provided the following information relevant to the listing and trading of the Notes:

The Notes, which will be registered under Section 12 of the Act, will be subject to Nasdaq's initial listing criteria for other securities under Rule 4420(f).⁶ The Notes will be subject to Nasdaq's continued listing criterion for other securities pursuant to Rule 4450(c). Under this criterion, the aggregate market value or principal amount of publicly held units must be at least \$1 million. The Notes also must have at least two registered and active market

⁶ Under NASD Rule 4420(f), Nasdaq may approve for listing and trading innovative securities that cannot be readily categorized under traditional listing guidelines. See Exchange Act Release No. 32988 (September 29, 1993); 58 FR 52124 (October 6, 1993). NASD Rule 4420(f)(1) sets forth issuer asset, holder, distribution, and market value/principal requirements. For example, the rule requires that the issuer have assets in excess of \$100 million and stockholders' equity of at least \$10 million. Merrill Lynch satisfies this listing criterion. For securities traded in less than \$1,000 denominations, there must be a minimum of 400 holders of the security. NASD Rule 4420(f)(2) requires issuers of securities designated pursuant to this paragraph to be listed on The Nasdaq National Market or the New York Stock Exchange, Inc. ("NYSE") or be an affiliate of a company listed on The Nasdaq National Market or the NYSE; provided, however, that the provisions of Rule 4450 will be applied to sovereign issuers of "other" securities on a case-by-case basis. Pursuant to Rule 4420(f)(3), prior to the commencement of trading of the Notes, Nasdaq will distribute a circular to members providing guidance regarding compliance responsibilities and requirements, including suitability recommendations, and

makers as required by Rule 4310(c)(1). Nasdaq specifically represents that it will commence delisting or removal proceedings with respect to the Notes (unless the Commission has approved the continued trading of the Notes) if any of the following standards are not continuously maintained:

(i) Each component security has a minimum market value of at least \$75 million, except that for each of the lowest weighted component securities in the Index that in the aggregate account for no more than 10% of the weight of the Index, the market value can be at least \$50 million;

(ii) Each component security shall have trading volume in each of the last six months of not less than 500,000 shares, except that for each of the lowest weighted component securities in the Index that in the aggregate account for no more than 10% of the weight of the Index, the trading volume shall be at least 400,000 shares for each of the last six months;

(iii) The total number of components in the Index may not increase or decrease by more than 33 1/3% from the number of components in the Index at the time of the initial listing of the Notes, and in no event may be fewer than ten (10) components;

(iv) As of the first day of January and July of each year, no underlying component security will represent more than 25% of the weight of the Index, and the five highest weighted component securities in the index do not in the aggregate account for more than 50% of the weight of the index;

highlighting the special risks and characteristics of the Notes. Nasdaq represents that these requirements will be satisfied.

(v) 90% of the Index's numerical value and at least 80% of the total number of component securities meet the then current criteria for standardized option trading of a national securities exchange or a national securities association;

(vi) Each component security (except foreign country securities) shall be issued by a 1934 Act reporting company and listed on a national securities exchange or Nasdaq; and

(vii) Foreign country securities or American Depositary Receipts ("ADRs") that are not subject to comprehensive surveillance agreements do not in the aggregate represent more than 20% of the weight of the Index.

Nasdaq will also commence delisting or removal proceedings with respect to the Notes (unless the Commission has approved the continued trading of the Notes) under any of the following circumstances:

(i) if the aggregate market value or the principal amount of the Notes publicly held is less than \$400,000;

(ii) if the value of the Index is no longer calculated or widely disseminated on at least a 15-second basis; or

(iii) if such other event shall occur or condition exists which in the opinion of Nasdaq makes further dealings on Nasdaq inadvisable.

Nasdaq will also consider prohibiting the continued listing of the Notes if Merrill Lynch is not able to meet its obligations on the Notes.

Because the Notes will be deemed equity securities for the purpose of Rule 4420(f), the NASD and Nasdaq's existing equity trading rules will apply to the Notes. Thus, Nasdaq states that, in accordance with NASD Rule 2310(a) and IM-2310-2, Nasdaq will advise members recommending a transaction in the Notes to have reasonable grounds for believing that the

recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. In addition, pursuant to Rule 2310(b), prior to the execution of a transaction in the Notes that has been recommended to a non-institutional customer, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member in making recommendations to the customer. Also, the Notes will be considered non-conventional investments for purposes of NASD's Notice to Members 03-71.⁷ Furthermore, the Notes will be subject to the equity margin rules. Lastly, the regular equity trading hours of 9:30 a.m. to 4:00 p.m. will apply to transactions in the Notes.

The Notes are a series of senior non-convertible debt securities that will be issued by Merrill Lynch and will not be secured by collateral. The Notes will be issued in denominations of whole units ("Unit"), with each Unit representing a single Note. The original public offering price will be \$10 per Unit. The Notes will not pay interest and are not subject to redemption by Merrill Lynch or at the option of any beneficial owner before maturity. The Notes' term to maturity is five years.

At maturity, if the value of the Index has increased, a beneficial owner of a Note will be entitled to receive the original offering price (\$10), plus an amount calculated by multiplying the original offering price (\$10) by an amount expected to be between 105% and 115% ("Participation Rate") of the percentage increase in the Index.⁸ If, at maturity, the value of the

⁷ See NASD, NTM 03-71 (November 2003), note 1.

⁸ The actual Participation Rate date will be determined on the day the Notes are priced for initial sale to the public and disclosed in the final prospectus supplement

Index has not changed or has decreased by up to 20%, then a beneficial owner of a Note will be entitled to receive the full original offering price.

However, unlike ordinary debt securities, the Notes do not guarantee any return of principal at maturity. Therefore, if the value of the Index has declined at maturity by more than 20%, a beneficial owner will receive less, and possibly significantly less, than the original offering price: for each 1% decline in the Index below 20%, the redemption amount of the Note will be reduced by 1.25% of the original offering price.

The change in the value of the Index will normally (subject to certain modifications explained in the prospectus supplement) be determined by comparing (a) the average of the values of the Index at the close of the market on five business days shortly before the maturity of the Notes to (b) the closing value of the Index on the date the Notes are priced for initial sale to the public. The value of the Participation Rate will be determined by Merrill Lynch on the date the Notes are priced for initial sale based on the market conditions at that time. Both the value of the Index on the date the Notes are priced and the Participation Rate will be disclosed in Merrill Lynch's final prospectus supplement, which Merrill Lynch will deliver in connection with the initial sale of the Notes.

The Notes are cash-settled in U.S. dollars and do not give the holder any right to receive a portfolio security, dividend payments, or any other ownership right or interest in the portfolio of securities comprising the Index. The Notes are designed for investors who want to participate or gain exposure to the Index, and who are willing to forego market interest payments on the Notes during the term of the Notes.

Pursuant to Securities Exchange Act Rule 10A-3 and Section 3 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), Nasdaq will prohibit the initial or

continued listing of any security of an issuer that is not in compliance with the requirements set forth therein.

Nasdaq represents that the NASD's surveillance procedures are adequate to properly monitor the trading of the Notes. Specifically, the NASD will rely on its current surveillance procedures governing equity securities and will include additional monitoring on key pricing dates.

III. Commission Findings

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of Section 15A of the Act,⁹ applicable to a national securities association, and, in particular, with the requirements of Section 15A(b)(6) of the Act,¹⁰ 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.¹¹

The Commission has previously approved the listing of securities with a structure similar to that of the Notes, which have been linked to, or based on, the Index or another broad-based index.¹² The Notes, however, are different from prior products because their return does not

⁹ 15 U.S.C. 78o-3.

¹⁰ 15 U.S.C. 78o-3(b)(6).

¹¹ 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).

¹² See, e.g., Securities Exchange Act Release Nos. 49301 (February 23, 2004), 69 FR 9665 (March 1, 2004) (approving the listing and trading of 97% principal protected notes linked to the Index); 48486 (September 11, 2003), 68 FR 54758 (September 18, 2003) (approving the listing and trading of contingent principal protected notes linked to the S&P 500 Index); 48152 (July 10, 2003), 68 FR 42435 (July 17, 2003) (approving the listing and trading of partial principal protected notes linked to the S&P 500 Index); 46883 (Nov. 21, 2002), 67 FR 71216 (Nov. 29, 2002) (approving the listing and trading of notes linked to the Index); 39525 (Jan. 8, 1998), 63 FR 2438 (Jan. 15, 1998)

directly correspond to the index performance when the index declines. Rather, for each 1% decline in the Index below 20%, the redemption amount of the Note will be reduced by 1.25% of the original offering price. However, NASD Rules 2310(a) and (b), along with NASD IM 2310-2, and NASD NTM 03-71 address member obligations with respect to customers of the Notes. Consequently, the Commission believes that it is appropriate to permit investors to benefit from the flexibility afforded by trading these products.

The hybrid listing standards set forth in NASD Rule 4420(f) were designed to address the concerns attendant to the trading of securities, like the Notes.¹³ The 30 component stocks that comprise the Index are reporting companies under the Act, and the Notes will be registered under Section 12 of the Act. Thus, by imposing the hybrid listing standards, heightened suitability, disclosure, and compliance requirements set forth in Nasdaq's proposal, the Commission should adequately address the potential problems that could arise from listing and trading 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. Among other things, the circular should indicate that the Notes do not guarantee a total return of principal at maturity; that for each 1% decline in the Index below

(approving the listing and trading of DIAMONDS Trust Units, portfolio depositary receipts based on the Index); and 39011 (Sept. 3, 1997), 62 FR 47840 (Sept. 11, 1997) (approving the listing and trading of options on the Index).

¹³ See Securities Exchange Act Release No. 32988 (September 29, 1993), 58 FR 52124 (October 6, 1993). For example, NASD Rule 4420(f) provides that only issuers satisfying substantial asset and equity requirements may issue securities such as the Notes. In addition, Nasdaq's continued listing criteria require that the Notes maintain a market value of at least \$1 million. See NASD Rule 4450(c).

20%, the redemption amount of the Note will be reduced by 1.25% of the original offering price; that the Participation Rate on the Notes is expected to be between 105% and 115% per unit; that the Notes will not pay interest; and that the Notes will provide exposure in the Index. The circular will also explain Merrill Lynch's calculation of the Notes' Participation Rate.

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.

In approving the product, the Commission recognizes that the Index is a price-weighted index of 30 of the largest and most active common stocks listed on Nasdaq and the NYSE. The Commission notes that the Index is determined, composed, and calculated by the editors of the WSJ, which is not a broker-dealer. The underlying stocks comprising the Index are well-capitalized, highly liquid stocks. Given the large trading volume and capitalization of each of the stocks underlying the Index, 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. Moreover, as noted above, the issuers of the underlying securities comprising the Index are subject to reporting requirements under the Act, and all of the component stocks are either listed or traded on, or traded through the facilities of, U.S. securities markets. In addition, NASD's surveillance procedures should serve to deter as well as detect any potential manipulation.

Regarding the systemic concern that a broker-dealer, such as Merrill Lynch, or a subsidiary providing a hedge for the issuer will incur position exposure, the Commission finds, as in previous approval orders for hybrid instruments similar to Notes issued by broker-dealers,

that this concern is minimal given the size of the Notes issuance in relation to the net worth of Merrill Lynch.¹⁴

Nasdaq also represents that index value of the Index is widely disseminated at least every 15 seconds. The Commission finds that such public dissemination of the index valuation will provide investors with timely and useful information concerning the value of their Notes.

The Commission finds good cause for approving proposed Amendment No. 2 before the thirtieth day of publication of notice of filing thereof in the Federal Register because Amendment No. 2 simply clarifies the continued listing criteria for the Notes.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether the amendment is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>);
- or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-139 on the subject line.

¹⁴ See *supra* note 12. See also Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Nasdaq-100 Index); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (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) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a weighted portfolio of the Healthcare/Biotechnology industry securities).

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-139. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 100 F Street, NE, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-139 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁵ that the proposed rule change, as amended by Amendment No. 1 (SR-NASD-2004-139), is hereby approved, and that Amendment No. 2 to the proposed rule change is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Jill M. Peterson
Assistant Secretary

¹⁵ 15 U.S.C. 78s(b)(2).

¹⁶ 17 CFR 200.30-3(a)(12).