

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51970; File No. SR-NASD-2004-131)

July 5, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto Relating to the Listing and Trading of Leveraged Index Return Notes Linked to the Nikkei 225 Index

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> notice is hereby given that on August 30, 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”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by Nasdaq. On March 21, 2005, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On March 31, 2005, Nasdaq filed Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to list and trade Leveraged Index Return Notes Linked to the Nikkei 225 Index (“Notes”) issued by Merrill Lynch & Co., Inc. (“Merrill Lynch”).

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

<sup>4</sup> In Amendment No. 2, Nasdaq set forth the standards that must be continuously maintained for Nasdaq not to commence delisting or removal proceedings with respect to the Notes.

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

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

Nasdaq proposes to list and trade the Notes. The Notes provide for a return based upon the Nikkei 225 Index (“Index”).

The Index

The Index is a stock index calculated, published and disseminated by Nihon Keizai Shimbun, Inc. (“NKS”)<sup>5</sup>, which measures the composite price performance of selected Japanese stocks. The Index is currently based on 225 common stocks traded on the Tokyo Stock Exchange (“TSE”) and represents a broad cross-section of Japanese industry. All 225 underlying stocks are listed in the First Section of the TSE and are,

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<sup>5</sup> Founded in 1876, NKS is a well-known provider of business information in Japan. It publishes several newspapers, including a large business daily, The Nihon Keizai Shimbun, and is also reportedly involved in a range of broadcasting and industrial activities. The Notes are not sponsored, endorsed, sold or promoted by NKS. NKS has no obligation to take the needs of Merrill Lynch or the holder of the Notes into consideration in determining, composing, or calculating the Nikkei. NKS is not responsible for, and has not participated in the determination of the timing of, prices for, or quantities of, the Notes to be issued or in the determination or calculation of the equation by which the Notes are to be settled in cash. NKS has no obligation or liability in connection with the administration or marketing of the Notes. NKS is not affiliated with a securities broker or dealer.

therefore, among the most actively traded stocks on the TSE. Futures and options contracts on the Index are traded on the Singapore International Monetary Exchange, the Osaka Securities Exchange, and the Chicago Mercantile Exchange.

The Index is a modified, price-weighted index, which means a component stock's weight in the Index is based on its price per share rather than total market capitalization of the issuer. NKS calculates the Index by multiplying the per share price of each component by the corresponding weighting factor for that component (a "Weight Factor"), calculating the sum of all these products and dividing that sum by a divisor. The divisor, initially set on May 16, 1949 at 225, was 22.999 as of August 19, 2004, and is subject to periodic adjustments as set forth below. Each Weight Factor is computed by dividing ¥50 by the par value of the relevant component, so that the share price of each component when multiplied by its Weight Factor corresponds to a share price based on a uniform par value of ¥50. Each Weight Factor represents the number of shares of the related component that are included in one trading unit of the Index. The stock prices used in the calculation of the Index are those reported by a primary market for the components, which is currently the TSE. The level of the Index is calculated once per minute during TSE trading hours. The value of the Index is readily accessible by U.S. investors at the following Web sites: [www.nni.nikkei.co.jp](http://www.nni.nikkei.co.jp) (the identity of the individual Index components can also be accessed from this site) and [www.bloomberg.com](http://www.bloomberg.com). As noted below, because of the time difference between Tokyo and New York, the closing level of the Index on a trading day will generally be available in the United States by the opening of business on the same calendar day.

In order to maintain continuity in the level of the Index in the event of certain

changes due to non-market factors affecting the components, such as the addition or deletion of stocks, substitution of stocks, stock dividends, stock splits or distributions of assets to stockholders, the divisor used in calculating the Index is adjusted in a manner designed to prevent any instantaneous change or discontinuity in the level of the Index. The divisor remains at the new value until a further adjustment is necessary as the result of another change. As a result of each change affecting any component, the divisor is adjusted in such a way that the sum of all share prices immediately after the change multiplied by the applicable Weight Factor and divided by the new divisor, i.e., the level of the Index immediately after the change, will equal the level of the Index immediately prior to the change.

Components may be deleted or added by NKS. However, to maintain continuity in the Index, the policy of NKS is generally not to alter the composition of the Index except when a component is deleted in accordance with the following criteria. Any stock becoming ineligible for listing in the First Section of the TSE due to any of the following reasons will be deleted from the Index: bankruptcy of the issuer, merger of the issuer into, or acquisition of the issuer by, another company, delisting of the stock or transfer of the stock to the “Seiri-Post” because of excess debt of the issuer or because of any other reason, or transfer of the stock to the Second Section of the TSE. Upon deletion of a stock from the Index, NKS will select, in accordance with certain criteria established by it, a replacement for the deleted component. In an exceptional case, a newly listed stock in the First Section of the TSE that is recognized by NKS to be representative of a market may be added to the Index. As a result, an existing component with low trading volume and not representative of a market will be deleted.

As of August 19, 2004, the average daily trading volume of an average Index component was approximately 2.95 million shares. As of the same date, the market capitalization of the components ranged from approximately 14.8 trillion yen to 28 billion yen. These figures correspond approximately to 136.5 billion U.S. dollars and 257 million U.S. dollars.

The Index is composed of 225 securities and is broad-based. As of August 19, 2004, the highest-weighted stock in the Index had the weight of 3.106%; all other components had lower weights. The top five stocks in the Index had the cumulative weight of approximately 13.474%.

The TSE is one of the world's largest securities exchanges in terms of market capitalization. Trading hours are currently from 9:00 A.M. to 11:00 A.M. and from 12:30 P.M. to 3:00 P.M., Tokyo time, Monday through Friday. Due to time zone difference, on any normal trading day the TSE will close prior to the opening of business in New York City on the same calendar day. Therefore, the closing level of the Index on a trading day will generally be available in the United States by the opening of business on the same calendar day.<sup>6</sup>

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<sup>6</sup> Nasdaq does not find it necessary to update during the U.S. trading day the closing value for the Nikkei 225 for foreign currency fluctuations because the return on this product is a U.S. Dollar amount based on the percentage change in value of the Nikkei 225 from the initial pricing date to the close of the market on five business days before the maturity date of the Notes. Nasdaq states that this is a "currency neutral" product because its pricing is based on the percentage increase or decrease of the Index value, as opposed to a derivative product, such as an exchange traded fund ("ETF"), where an intraday update of the product's estimated value is adjusted (when the overseas trading market is closed during the U.S. trading day) for foreign currency fluctuations. To have the estimated value of an ETF, during the U.S. trading day, reflect changes in currency exchange rates between the U.S. Dollar and the applicable foreign currency is useful to the creation and redemption process (which involves purchasing component securities affected by currency fluctuations in some cases) and thus the secondary market trading of the derivative product. Telephone Conference on June 24, 2005

The TSE has adopted certain measures, including daily price floors and ceilings on individual stocks, intended to prevent any extreme short-term price fluctuations resulting from order imbalances. In general, any stock listed on the TSE cannot be traded at a price lower than the applicable price floor or higher than the applicable price ceiling. These price floors and ceilings are expressed in absolute Japanese yen, rather than percentage limits based on the closing price of the stock on the previous trading day. In addition, when there is a major order imbalance in a listed stock, the TSE posts a “special bid quote” or a “special asked quote” for that stock at a specified higher or lower price level than the stock’s last sale price in order to solicit counter-orders and balance supply and demand for the stock. The TSE may suspend the trading of individual stocks in certain limited and extraordinary circumstances, including, for example, unusual trading activity in that stock. As a result, changes in the Index may be limited by price limitations or special quotes, or by suspension of trading, on individual stocks that comprise the Index, and these limitations may, in turn, adversely affect the value of the Notes.

NKS is under no obligation to Merrill Lynch to continue the calculation and dissemination of the Index. In the event the calculation and dissemination of the Index is discontinued, Nasdaq will delist the Notes.

If manipulative activity or other types of trading activity that raise regulatory concerns are suspected and involve Index component stocks, the NASD will rely on the Intermarket Surveillance Group Agreement to obtain the needed information from the TSE. This Agreement obligates the NASD and the TSE (among others) to compile and

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among Alex Kogan, Associate General Counsel, Nasdaq and Florence Harmon, Senior Special Counsel and Mitra Mehr, Staff Attorney, Division of Market Regulation, Commission (“June 24 Telephone Conference”).

transmit market surveillance information and resolve in good faith any disagreements regarding requests for information or responses thereto. Also, if it ever became necessary (for example, if, hypothetically, the TSE withdrew from the Intermarket Surveillance Group Agreement), NASD would seek the Commission's assistance pursuant to memoranda of understanding or similar intergovernmental agreements or arrangements that may exist between the Commission and the Japanese securities regulators. Nasdaq represents that it will file the appropriate proposed rule change pursuant to Rule 19b-4 in the event that Nasdaq is unable to obtain surveillance sharing information via the Intermarket Surveillance Group.<sup>7</sup>

#### Other Information

Under Rule 4420(f), Nasdaq may approve for listing and trading innovative securities that cannot be readily categorized under traditional listing guidelines.<sup>8</sup>

Nasdaq proposes to list the Notes for trading under Rule 4420(f).

The Notes, which will be registered under Section 12 of the Act, will initially be subject to Nasdaq's listing criteria for other securities under Rule 4420(f). Specifically, under Rule 4420(f)(1):

- (A) The issuer shall have assets in excess of \$100 million and stockholders' equity of at least \$10 million.<sup>9</sup> In the case of an issuer which is unable to satisfy the income criteria set forth in paragraph (a)(1), Nasdaq generally will require the issuer to have the following: (i) assets in

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<sup>7</sup> Clarification provided in June 24 Telephone Conference.

<sup>8</sup> See Securities Exchange Act Release No. 32988 (September 29, 1993), 58 FR 52124 (October 6, 1993) (SR-NASD-93-15) (approving listing standards for hybrid securities).

excess of \$200 million and stockholders' equity of at least \$10 million;  
or (ii) assets in excess of \$100 million and stockholders' equity of at  
least \$20 million;

- (B) There must be a minimum of 400 holders of the security, provided, however, that if the instrument is traded in \$1,000 denominations, there must be a minimum of 100 holders;
- (C) For equity securities designated pursuant to this paragraph, there must be a minimum public distribution of 1,000,000 trading units; and
- (D) The aggregate market value/principal amount of the security will be at least \$4 million.

In addition, Merrill Lynch satisfies the listed marketplace requirement set forth in Rule 4420(f)(2).<sup>9</sup> Lastly, 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 highlighting the special risks and characteristics of the Notes. In particular, in accordance with NASD Rule 2310(a), 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

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<sup>9</sup> Merrill Lynch satisfies this listing criterion.

<sup>10</sup> 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 ("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.



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.

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 makers as required by Rule 4310(c)(1). Nasdaq will also consider prohibiting the continued listing of the Notes if Merrill Lynch is not able to meet its obligations on 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 of the Notes 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 4½ 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 equal to 123% ("Participation Rate") of the percentage increase in the Index. If, at maturity, the value of the 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 were priced for initial sale to the public. The value of the Participation Rate (which, as indicated above, is 123%) was determined by Merrill Lynch on the date the Notes were priced for initial sale based on the market conditions at that time. Both the value of the Index on the date the Notes were priced and the Participation Rate were disclosed in Merrill Lynch's final prospectus supplement, which Merrill Lynch delivered in connection with the 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. The Commission

has previously approved the listing of other securities the performance of which has been linked, in whole or in part, to the Index.<sup>11</sup>

Since 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. First, pursuant to Rule 2310 and IM-2310-2, members must have reasonable grounds for believing that a recommendation to a customer regarding the purchase, sale or exchange of any security 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.<sup>12</sup> Members are also reminded that the Notes are considered nonconventional investments for purposes of the NASD Notice to Members 03-71 (Nov. 2003). In addition, as previously described, Nasdaq will distribute a circular to members providing guidance regarding compliance responsibilities and requirements, including suitability recommendations, and highlighting the special risks and characteristics of the Notes.

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<sup>11</sup> See Securities Exchange Act Release Nos. 49670 (May 7, 2004), 69 FR 27959 (May 17, 2004) (SR-NASD-2004-068) (approving listing and trading of Accelerated Return Notes Linked to the Nikkei 225 Index); 49715 (May 17, 2004), 69 FR 29597 (May 24, 2004) (SR-NASD-2004-061) (approving listing and trading of 97% Protected Notes Linked to the Performance of the Global Equity Basket, which included the Index); 38940 (August 15, 1997), 62 FR 44735 (August 22, 1997) (SR-Amex-97-20) (approving listing and trading of Market Index Target-Term Securities, return on which is based on changes in value of portfolio of 11 foreign indexes, including the Index); and 27565 (December 22, 1989), 55 FR 376 (January 4, 1990) (approving listing of Index Warrants based on the Nikkei Stock Average and noting the existence of a Memorandum of Understanding between the Commission and the Japanese Ministry of Finance for surveillance purposes).

<sup>12</sup> Rule 2310(b) requires members to make reasonable efforts to obtain information concerning a customer's financial status, a customer's tax status, the customer's investment objectives, and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

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.

Pursuant to Securities Exchange Act Rule 10A-3<sup>13</sup> 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. In connection with initial distributions of its Nasdaq-listed notes, Merrill Lynch is required to deliver the appropriate prospectus.

Nasdaq 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

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17 CFR 240.10A-3

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;
- (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;<sup>14</sup> and
- (vi) Foreign country securities or American Depository Receipts 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:

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<sup>14</sup> In a telephone conference, Nasdaq agreed with the SEC staff that the additional standard, proposed by Nasdaq, set forth in Amendment No. 2 is inapplicable with respect to the Notes. This standard stated that "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." June 24, 2005 Telephone Conference.

- (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;<sup>15</sup> or
- (iii) if such other event shall occur or condition exists which in the opinion of Nasdaq makes further dealings on Nasdaq inadvisable.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A of the Act,<sup>16</sup> in general, and with Section 15A(b)(6) of the Act,<sup>17</sup> in particular, in that the proposal 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, in general, to protect investors and the public interest. Specifically, the proposed rule change will provide investors with another investment vehicle based on the Index.

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

Nasdaq does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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<sup>15</sup> As noted, because of the time difference between Tokyo and New York, the closing value of the Index will be disseminated.

<sup>16</sup> 15 U.S.C. 78o-3.

<sup>17</sup> 15 U.S.C. 78o-3(b)(6).

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

Written comments were neither solicited nor received.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, as amended, or

(B) institute proceedings to determine whether the proposed rule change, as amended, should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-131 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2004-131. 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 Room. 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-2004-131 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>18</sup> 17 CFR 200.30-3(a)(12).