

broad-based indices under CBOE Rule 24.4(a).<sup>12</sup>

#### *H. Exchange Rules Applicable*

Except as modified herein, the Rules in Chapter XXIV will be applicable to both CBOE Euro 25 Index options and CBOE Asian 25 Index options. Index option contracts based on both the CBOE Euro 25 Index and the CBOE Asian 25 Index will be subject to the position limit requirements of CBOE Rule 24.4(a). Additionally, CBOE affirms that it possesses the necessary systems capacity to support a new series that would result from the introduction of both CBOE Euro 25 Index options and CBOE Asian 25 Index options. CBOE has also been informed that OPRA has the capacity to support such new series.

### **III. Discussion**

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5) of the Act,<sup>13</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>14</sup> Specifically, the Commission finds that the listing and trading of options on the Euro 25 Index and Asian 25 Index will permit investors to participate in the price movements of large market capitalization companies in their respective regions on which the indices are based. The Commission also believes that the listing and trading of options on the Euro 25 Index and Asian 25 Index will allow investors holding positions in some or all of the securities underlying the Indexes to hedge the risks associated with their portfolios. Accordingly, the Commission believes that the Indexes will provide investors with an important trading and hedging mechanism that should reflect accurately the overall movement of highly market capitalized European Union and Asian equity securities. By broadening the hedging and investment opportunities of investors, the Commission believes that the trading of these index options will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets.<sup>15</sup> Nevertheless,

the trading of options on the Euro 25 Index and Asian 25 Index raises several issues related to the design and structure of the Indexes, customer protection, surveillance, and market impact. The Commission believes, however, that the CBOE has adequately addressed these issues for the reasons discussed below.

#### *A. Index Design and Structure*

The Commission finds that it is appropriate and consistent with the Act to classify the Index as broad-based, and therefore to permit CBOE's rules applicable to the trading of broad-based index options to apply to these Index options. First, both the Euro 25 Index and Asian 25 Index consists of 25 actively traded equity securities. Second, the Euro 25 Index and Asian 25 Index each consist of 25 of the most highly capitalized securities and ADRs in their respective regions. For example, CBOE represented in the proposing release that on December 20, 2002, the market capitalization of the individual securities in the Euro 25 Index ranged from a high of \$97.208 billion to a low of \$5.37 billion, with a mean value of \$30.326 billion. The market capitalization of the individual securities in the Asian 25 Index ranged from a high of \$49.140 billion to a low of \$382.722 million, with a mean value of \$10.696 billion. Third, CBOE's maintenance criteria require that at least 75% of each Index, in terms of market capitalization, must meet the listing criteria for equity options set forth in CBOE Rule 5.3, the minimum market capitalization of component securities is \$250 million, and component securities must have a trading volume of 500,000 shares in each of the previous six months. The Commission believes that CBOE's maintenance criteria will help ensure that the Indexes continue to be comprised of component securities that are highly capitalized and actively traded. Fourth, CBOE's maintenance criteria require that no single component security will represent more than 30% of the weight of the index. The Commission believes that this will help to ensure that the index maintains its broad representative sample of securities in the Euro 25 Index and

Asian 25 Index and that no single or small group of securities dominate the Indexes.

The Commission also believes that the general broad diversification of the Indexes' component securities, as well as their high capitalization and trading activity, minimize the potential for manipulation of the Indexes. First, as discussed above, the Euro 25 Index and Asian 25 Index represent a broad cross-section of highly-capitalized securities, with no single industry group or component security dominating each Index. Second, the securities underlying each Index are relatively actively traded. Third, the Commission believes that the Index continues to represent securities with the highest capitalization and trading volume. In addition, the CBOE has proposed position and exercise limits for the Indexes that are consistent with other broad-based index options.

#### *B. Customer Protection*

The Commission believes that a regulatory system designed to protect public customers must be in place before the trading of sophisticated financial instruments, such as the Euro 25 and Asian 25 Index options (including full-value and reduced-value Index LEAPS), can commence on a national securities exchange. The Commission notes that the trading of standardized exchange-traded options occurs in an environment that is designed to ensure, among other things, that: (1) The special risks of options are disclosed to public customers; (2) only investors capable of evaluating and bearing the risk of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the index options and index LEAPS will be subject to the same regulatory regime as the other standardized options traded on the CBOE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in Euro 25 and Asian 25 Index options and Index LEAPS.<sup>16</sup>

#### *C. Surveillance*

In evaluating derivative instruments, the Commission, consistent with the protection of investors, considers the degree to which the derivative instrument is susceptible to manipulation. The ability to obtain information necessary to detect and

<sup>12</sup> Specifically, CBOE Rule 24.4(a) imposes a standard position limit of 50,000 contracts on the same side of the market for CBOE's Mexico 30 Index and CBOE's Germany 25 Index.

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

<sup>14</sup> In approving this rule, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>15</sup> Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new securities product upon a finding that the introduction of such product is in the public

interest. Such a finding would be difficult with respect to a product that served no hedging or other economic function because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed Index options will provide investors with a hedging vehicle that should reflect the overall market of securities representing a segment of the U.S. securities market.

<sup>16</sup> In addition, CBOE has represented that it and the Options Price Reporting Authority ("OPRA") have the necessary systems capacity to support these new series of options that would result from the introduction of Index options and Index LEAPS. See letter from Joe Corrigan, Executive Director, OPRA, to John Hiatt, CBOE, dated July 11, 2002.