

deter market manipulation and other trading abuses is a critical factor in the Commission's evaluation. It is for this reason that it is important that the Commission determine that there is an adequate mechanism in place to provide for the exchange of information between the market trading the derivative product and the market on which the securities underlying the derivative product are traded. Such mechanisms enable officials to surveil trading in both the derivative product and the underlying securities. For foreign stocks index derivative products, such mechanisms are especially important for the relevant foreign and domestic exchanges to facilitate the collection of necessary regulatory, surveillance and other information.

As a general matter, the Commission believes that comprehensive surveillance sharing agreements between the relevant foreign and domestic exchanges are important where an index derivative product comprised of foreign securities is to be traded in the United States.<sup>17</sup> In absence of comprehensive surveillance sharing agreements between the foreign and domestic exchanges, the Commission has relied in the past on surveillance sharing arrangements between the relevant regulators. In the context of ADRs, the Commission believes that, in most cases, the relevant underlying equity market is the primary market on which the security underlying the ADR trades. This is because, in most cases, the market for the security underlying the ADR generally is larger in comparison to the ADR market, both in terms of share volume and the value of trading. Because of the additional leverage provided by options on an ADR, the Commission generally believes that having a comprehensive surveillance sharing agreement in place between the foreign and domestic exchanges will ensure the integrity of the market.

Under CBOE's current proposal, however, the Commission believes that it is appropriate to permit the listing and trading of options on an ADR without the existence of a comprehensive surveillance sharing agreement with the foreign market where the underlying security trades, as

long as the U.S. market for the underlying ADRs is at least as large as the market for the underlying foreign security. Specifically, the proposed listing standards require that any non-U.S. component security (common stock or ADR) that is not subject to a comprehensive surveillance sharing agreement shall not in the aggregate represent more than 20% of the weight of each Index's market capitalization, unless those non-U.S. components satisfy the alternative criteria under Interpretation and Policy .03 to CBOE Rule 5.3.<sup>18</sup>

According to the CBOE, 23 of the 24 ADR or NYS component securities of the Euro 25 Index are subject to comprehensive surveillance sharing agreements. Further, 13 of the 25 component securities of the Asian 25 Index are either subject to comprehensive surveillance sharing agreements, or are common stocks. The ADR components of the Asian 25 Index that are not subject to comprehensive surveillance agreements satisfy the alternative criteria in Interpretation and Policy .03 of CBOE Rule 5.3. In addition, 21 of the 25 component securities or approximately 89% of the aggregate index market capitalization of the Asian 25 Index do satisfy CBOE's acceptable listing standards. The Commission believes that CBOE's standards will ensure that the relevant pricing market for the options on ADRs is the U.S. ADR market rather than the market where the security underlying the ADR trades. In these cases, the Commission believes that the U.S. ADR market is the instrumental market for purposes of deterring and detecting potential manipulation or other abusive trading strategies in conjunction with transactions in the overlying ADR options market. The CBOE represented that it will use the same surveillance procedures currently utilized for each of the Exchange's other index options to monitor trading in options and LEAPS, and that its surveillance procedures are

adequate to monitor the trading of these products.

#### *D. Market Impact*

The Commission believes that the listing and trading of Euro 25 and Asian 25 Index options on the CBOE will not adversely affect the underlying securities markets. First, as described above, both Indexes are broad-based and comprised of 25 securities with no one component or industry group dominating the Index. Second, as noted above, the component securities contained in the Indexes all have large market capitalizations and are actively traded. Third, existing CBOE index options rules and surveillance procedures will apply to Euro 25 and Asian 25 Index options. Fourth, the position limits of 50,000 contracts on either side of the market, with no more than 30,000 of such contracts in a series in the nearest month expiration month, will serve to minimize potential manipulation and market impact concerns. Fifth, the risk to investors of contra-party non-performance will be minimized because the Index options will be issued and guaranteed by the Options Clearing Corporation just like any other standardized option traded in the United States.

Furthermore, the Commission notes that absent prior SEC approval, the component securities in either Index will not exceed 40 or be lower than 20 and shall satisfy CBOE's maintenance criteria. If an Index fails at any time to satisfy the maintenance criteria, CBOE will immediately notify the Commission of the fact and will not open for trading any additional series of options on the Index unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of options on each respective Index has been approved by the Commission under Section 19(b)(2) of the Exchange Act.

The Commission finds good cause for approving the proposed rule change and Amendment Nos. 1 and 2 thereto prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The proposed rule change, as amended by Amendment No. 1, has been published for public comment in the **Federal Register** as of February 5, 2003. The Commission has not received any comments on the proposal. Further, the Commission notes that Amendment No. 2 does not change the proposed rule change; rather, CBOE requests that the Commission accelerate the effectiveness of the proposal so that the CBOE may begin the trading of the Euro 25 Index and

<sup>17</sup> The Commission believes that a comprehensive surveillance sharing agreement should provide the parties thereto with the ability to obtain information necessary to detect and deter market manipulation and other trading abuses. Consequently, the Commission generally requires that such agreements require that the parties provide each other, upon request, information about market trading activity, clearing activity, and the identity of the purchasers and sellers of securities underlying the derivative product.

<sup>18</sup> Specifically, the Commission notes that: (1) As provided in Interpretation and Policy .03(ii) to CBOE Rule 5.3, an individual ADR without a comprehensive surveillance sharing agreement will satisfy CBOE's listing criteria if over 50% of the combined worldwide trading volume in the ADR occurs in the U.S. ADR market for the previous three months from date of selection; or (2) as provided in Interpretation and Policy .03(iii) to CBOE Rule 5.3, an individual ADR without a comprehensive surveillance sharing agreement will satisfy CBOE's listing criteria if: (a) At least 20% of the worldwide trading volume in that foreign security occurs within the U.S. market and a market for which CBOE has a comprehensive surveillance agreement; (b) the average daily trading volume of the ADR over the past 3 months is 100,000 shares or more; and, (c) the trading volume is at least 60,000 shares per day in U.S. markets on a majority of trading days during the past months.