

the NYSE. In addition, the Revised NYSE Composite Index would be calculated using a float-adjusted market capitalization weighting method instead of a full-market capitalization weighting, as was used in the Old Index.⁶ The float-adjusted market capitalization method is used to reflect only the number of shares that are actually available to investors.⁷ The Revised NYSE Composite Index will be maintained and calculated by the Dow Jones. Maintenance includes monitoring and implementing the adjustments for company additions and deletions, share changes, stock splits, stock dividends, corporate restructurings, spin-offs and other corporate actions.

The CBOE has proposed to list and trade options based on one-tenth (1/10th) the value of the Revised NYSE Composite Index as well as LEAPS and reduced-value LEAPS on the Revised NYSE Composite Index. The Revised NYSE Composite Index, unlike the Old Index, is a broad-based index designed to reflect the actual number of shares available to investors, and will be treated as a broad-based index under CBOE Rules. All other material terms to the options on the Revised NYSE Composite Index remain the same as those of the Old Index. Accordingly, options on the index would continue to have a.m., European style settlement, the same position and exercise limits as the Old Index options and broad based index options margin.

III. Discussion

The Commission has carefully reviewed the CBOE's proposed rule change and finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁸ and with the requirements of section 6(b) of the Act.⁹ In particular, the Commission finds that

the proposed rule change is consistent with section 6(b)(5)¹⁰ of the Act which requires that the Exchange's rules be 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 a national market system, and, in general, to protect investors and the public interest. While the Exchange does not believe that these changes will result in any material differences in the manner in which options on the Reduced Value Index will trade, the Commission believes that certain issues need to be addressed, including the float-adjusted market capitalization method for the index.

The Commission believes that index options on the Revised NYSE Composite Index should be beneficial to members that want to track the New York Stock Exchange equity markets, and could provide a useful hedging vehicle for such investors.¹¹ Because the Revised NYSE Composite Index is intending to track the NYSE's equity markets as a whole, the index is appropriately treated as a broad-based index option under CBOE rules, and for regulatory purposes.

As noted above, the float-adjusted market capitalization eliminates certain holdings that are not freely available from the capitalization calculation. This is the first index option CBOE will be trading using this method of calculation for the underlying index. The Commission believes that this newly-developed method for calculating the index value could help to relieve the potential price distortions that could result from including in the index the entire capitalization of a company with limited free float. While this somewhat reduces the overall capitalization of the Revised NYSE Composite Index, the capitalization of this index will still remain extremely large.

The Commission also notes that while the Exchange's proposal to list and trade options at one-tenth (1/10th) of the value of the underlying index represents a departure from the calculation used in

the Old Index, the Commission does not believe that this should raise concerns. The purpose behind this change is to reduce the extremely large contract size that would result from pairing the standard contract multiplier with such a high underlying index level.¹² Such a reduction will provide investors with product offerings that are consistent with those available for the Old Index. Because the reduction in contract size is intended to have the index value be reduced to levels similar to the contract size on the Old Index, the Commission has determined that it is appropriate to apply the same position and exercise limits applicable to the Old Index options to the new option contracts on the Revised NYSE Composite Index. Further, the 45,000-contract limit with a reduction to 25,000 contracts in the near-term months, is equivalent to the position and exercise limits applicable to other similar broad-based indices.

The Commission notes that margin requirements and other material terms of the options, such as a.m. settlement, will remain unchanged, and, as such, the trading of options on the Revised NYSE Composite Index does not raise any new issues in these areas. CBOE has stated that it will apply its existing surveillance procedures to monitor trading in options on the Revised NYSE Composite Index. The Commission believes that these procedures should be sufficient to detect as well as deter manipulation and other trading abuses.

Finally, the CBOE has agreed to send a circular to members discussing the Revised NYSE Composite Index and the index options that will be traded on CBOE on the Revised NYSE Composite Index. The circular will discuss the new float-adjusted market capitalization method. The Commission believes that this will be useful since the Old Index had a different calculation method and this is the first time that CBOE will be trading index options using a float-adjusted market capitalization method. The Revised NYSE Composite Index will also have a different symbol than the one used for the Old Index. These efforts should help to avoid investor confusion relating to options on the Old Index and the Revised NYSE Composite Index.

⁶ The CBOE states that all option series on the Old Index have expired and no new series in Old Index Options have been added or will be added.

⁷ In calculating this number of shares, the float-adjusted market capitalization methodology will reduce each underlying issuer's market share in the Revised NYSE Composite Index by the market capitalization value represented by those shares held through 5% or more block ownership. The following types of ownership are considered block ownership: cross ownership (shares that are owned by other companies); government ownership (shares that are owned by governments or their agencies); private ownership (shares that are closely held by individuals, families or charitable trusts and foundations); and restricted shares (shares that are not allowed to be traded during a certain period of time).

⁸ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f.

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ 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 index options on the Revised NYSE Composite Index will provide investors with a hedging vehicle for all equity securities traded on the NYSE.

¹² The Old Index was calculated to a base of 500 and, after multiplying by the standard \$100 contract multiplier, the contract size was \$50,000. The Revised NYSE Composite Index is calculated to a base of 5,000, which, after multiplying by the standard \$100 contract multiplier, yields a contract size of \$500,000. To address this extremely large contract size, the CBOE has proposed to list and trade options based on 1/10th of the value of the Revised NYSE Composite Index. This translates to a contract size of \$50,000, which is the same as that of the Old Index.