

of less than \$100 million, and securities representing 2.19% of the capitalization of the Index had average daily trading volumes of less than 10,000 shares over the previous six months.

Index Option Trading

As noted above, the Exchange proposes to trade Full-Size Index Options, Mini Index Options, FLEX Index Options, and Mini-Flex Index Options. The contract multiplier for Full-Size Index Options will be \$100 and the contract multiplier for Mini Index Options will be \$10. Each contract will trade under separate ticker symbols and will not be fungible with the other. The size of the underlying Index will remain the same for each contract (*i.e.*, Mini Index Options will not overlie a separate index calculation reduced by 1/10th) and the PHLX represents that it will list similar strikes for each and the settlement values will be uniform.

The Exchange will list strike prices in \$5.00 intervals for the Index Options. The minimum tick size for series quoted below \$3.00 (*i.e.*, \$300 in premium after factoring in the \$100 contract multiplier for Full-Size Index Options and \$30 in premium after factoring in the \$10 contract multiplier for Mini Index Options) will be \$.05 (*i.e.*, \$5.00 for Full-Size Index Options, and \$.50 for Mini Index Options), and for the series quoted above \$3.00 the minimum tick size will be \$.10 (*i.e.* \$10.00 for Full-Size Index Options and \$1.00 for Mini Index Options).

The PHLX represents that it has adequate system capacity to trade the Index Options.¹⁶ In addition, the PHLX represents that the Options Price Reporting Authority ("OPRA") informed the Exchange that trading in the Index Options will have minimal impact on OPRA's current quoting capacity.¹⁷

Settlement of Index Options

The Full-Size Index Options and Mini Index Options will expire on the Saturday following the third Friday of the expiration month.¹⁸ Trading in the expiring contract month will normally cease at 4:15 p.m. ET on the immediately preceding Thursday. Nasdaq will calculate the exercise

settlement value of the Index at option expiration based on the volume-weighted opening price ("Nasdaq VWOP") of the component securities in the first four minutes of trading (the "Extraction Period") on the business day prior to expiration, which normally will be a Friday. Each Index component will have a trade extraction history independently maintained beginning with the receipt of the first day's trade in that issue and continuing for four continuous minutes. Nasdaq will record and reflect trade adjustments during the Extraction Period for each component until the four-minute window for the last component stock closes or 10:30 a.m., whichever is sooner. Nasdaq will then calculate the Nasdaq VWOP for each security based on the extracted trades and aggregate the Nasdaq VWOPs of the Index's components to calculate the Index settlement value. If a stock fails to open for trading, the last available price on the stock will be used to calculate the Index, as is done for currently listed indexes. A stock will be deemed to have failed to open for trading when it does not open for trading prior to 10:30 a.m. on such trading day.

Surveillance

To monitor trading in the Index Options, the Exchange will use the same surveillance procedures it uses currently for the Exchange's sector index options. These procedures include complete access to trading activity in the underlying securities. The Intermarket Surveillance Group ("ISG") Agreement, dated July 14, 1983, as amended, will be applicable to the trading of the Index Options. According to the PHLX, as of July 31, 2003, 315 Index components representing 3.27% of the weight of the Index are the securities of entities incorporated outside the United States. Of those securities, only 125, or 0.64% of the capitalization of the Index, are the securities of companies incorporated in countries whose domestic equity exchange is not a member of ISG.

Position Limits

The PHLX proposes to amend PHLX Rule 1001A, "Position Limits," to establish position limits of 50,000 contracts for Full-Size Index Options, with 30,000 contracts in the nearest expiration month, and 500,000 contracts for Mini Index Options on either side of the market, with 300,000 contracts total in the nearest expiration month. Exercise limits will be set at the same level as position limits. The proposed amendment to PHLX Rule 1001A will require that the position limits in Full-

Size Index Options and Mini Index Options be aggregated for the purpose of determining compliance with position and exercise limits. The PHLX proposes to establish the position limit of the index hedge exemption at 150,000 contracts for Full-Size Index Options and 1,500,000 contracts for Mini Index Options.

The Exchange proposes to amend PHLX Rule 1079, "FLEX Index and Equity Options," to establish a separate position limit of 50,000 contracts on the same side of the market for FLEX Index Options, with 30,000 contracts on the same side of the market in the nearest expiration month. For Mini-Flex Index Options, the PHLX proposes to establish a position limit of 500,000 contracts on the same side of the market, with 300,000 contracts on the same side of the market in the nearest expiration month.

III. Summary of Comments

The Commission received two comment letters¹⁹ regarding the proposal, which raise several concerns with respect to the exclusive licensing agreement PHLX entered into with Nasdaq, the Index licensor, to list and trade the Index Options.²⁰ The commenters maintain that the PHLX's proposal fails to explain why, in light of the exclusive licensing agreement, the proposal does not impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act as required in Form 19b-4. One commenter also expresses concern that the terms of the exclusive licensing agreement could create a conflict between the PHLX's financial interests and its obligation to fairly monitor trading in the Index Options, because, according to the commenter, the licensing agreement might impose financial penalties on the PHLX if trading in the Index Options fails to meet specified volume thresholds.²¹ In addition, the commenter asserts that the exclusive licensing agreement could lead to order routing biases.²²

In response, the PHLX argues that its exclusive licensing agreement with Nasdaq will not inhibit competition.²³ Specifically, the PHLX maintains that the Index Options will compete with other index options and other investment products, such as equity options and options on ETFs. Further,

¹⁶ See letter from Thomas A. Wittman, Senior Vice President, Trading Floor Development, PHLX, to Yvonne Fraticelli, Division, Commission, dated October 7, 2003.

¹⁷ See letter from Joseph P. Corrigan, Executive Director, OPRA, to Matthew Holm, Director, PHLX, dated September 16, 2003.

¹⁸ Under PHLX Rule 1079(a)(6), a FLEX option on the Index may not expire on any day that falls on or within two business days prior to or subsequent to an expiration day for a non-FLEX option on the Index.

¹⁹ See note 6 *supra*.

²⁰ The Commission notes that ISE specifically stated that it did not object to the PHLX's proposal to trade the Index Options. See ISE Letter, note 6 *supra*.

²¹ See PCX Letter, note 6, *supra*.

²² See PCX Letter, note 6, *supra*.

²³ See PHLX Letter, note 7, *supra*.