

PHLX argued that the Commission should consider comments relating to its exclusive licensing agreement in light of other similar investment products, such as the Nasdaq 100 Index Tracking Stock, Nasdaq 100 Index Tracking Stock options, and the Fidelity Nasdaq Composite Index Tracking Stock. PHLX believes that the existence of these similar competing products negates the argument that the exclusive licensing agreement imposes a burden on competition. In addition, the PHLX states that Nasdaq and the PHLX have limited the term of exclusively to three years, thereby preserving the PHLX's incentives to promote and facilitate the sale of the Index Options while allowing Nasdaq to seek other promoters of its intellectual property if the PHLX's performance fails to meet expectations. The PHLX believes that its exclusive licensing agreement with Nasdaq increases the PHLX's incentive to promote the Index Options, which should enhance competition.

In response to the commenter's concerns about potential conflicts of interest, the PHLX argues that the Exchange has no conflict of interest because it intends to pass on the licensing fees in pays Nasdaq to the specialist to whom the PHLX allocates the Index Options.²⁴ Because the PHLX will pass on the licensing fees to the specialist, the PHLX will not experience any financial penalty as a result of a disappointing performance in the licensed product. In addition, the PHLX maintains that its executive licensing agreement with Nasdaq eliminates any conflict of interest between the PHLX's regulatory and financial obligations because the agreement imposes no financial penalties of the PHLX if it fails to reach certain volume thresholds. The PHLX also states that the excluding licensing agreement provides no incentive for the PHLX to inflate trading volumes artificially.

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of Section 6(b)(5) of the Act.²⁵ The Commission

finds that the trading of Full-Size Index Options, Mini Index Options, FLEX Index Options, and Mini-Flex Options will permit investors to participate in the price movements of the securities listed and traded on Nasdaq. The Commission also believes that the trading of the Index Options will allow investors holding positions in some or all of the securities underlying the Index to hedge the risks associated with their portfolios, and that the trading of FLEX Index Options and Mini-Flex Index Options will provide investors with additional flexibility in hedging the risks associated with holding some or all of the Index's component securities.²⁶ Accordingly, the Commission believes that Index Options will provide investors with an important trading and hedging mechanism. By broadening the hedging and investment opportunities of investors, the Commission believes that the trading of Index Options will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets.²⁷

The trading of Index Options, however, raises several issues, including issues related to index design, customer protection, surveillance, and market impact. For the reasons discussed below, the Commission believes that the PHLX has adequately addressed these issues.

A. Index Design and Structure

The Commission finds that it is appropriate and consistent with the Act to classify the Index as broad-based for purposes of index option trading, and therefore appropriate to permit PHLX

²⁶ The Commission previously has approved the listing and trading by the PHLX of FLEX equity and index options. See Securities Exchange Act Release No. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998) (order approving File No. SR-PHLX-96-38) ("January 23, 1998") (order approving File No. SR-PHLX-96-38) ("FLEX Order"). The Commission's findings and discussion in the FLEX Order with respect to FLEX index options are incorporated by reference herein.

²⁷ Pursuant to Section 6(b)(5) of the Act, the Commission must predicate approval of any new option or warrant proposal upon a finding that the introduction of such new derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument 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 will provide investors with a hedging vehicle that should reflect the overall movement of the Nasdaq market. The Commission also believes that the Index Options will provide investors with a means by which to make investment decisions in the Nasdaq market, allowing them to establish positions or increase positions in Nasdaq market stocks in a cost effective manner.

rules applicable to the trading of broad-based options to apply to the Index Options. Specifically, the Commission believes that the Index is broad-based because it reflects a substantial segment of the U.S. equities market. First, as described more fully above, the Index is comprised of approximately 3,400 securities and includes all of the foreign and domestic ADRs, common stocks, ordinary shares, REITs, shares of beneficial interest, and tracking stocks listed and traded on Nasdaq. According to the PHLX, as of July 31, 2003, component securities representing 95% of the weight of the Index were options eligible.²⁸ Second, the Index includes ten industry groups, with the top five industry groups weighted in the Index as of July 31, 2003, as follows: (1) computer software and hardware, 52%; (2) healthcare, 14%; (3) financials, 11%; (4) consumer discretionary, 8%; and (5) telecommunications and media, 6%. Third, as of July 31, 2003, the total capitalization of the Index was \$2.6 trillion, the capitalization of the Index's components ranged from \$284 billion to \$55,000,²⁹ and the medium capitalization of the Index's components was \$110 million. As of July 31, 2003, the largest Index component accounted for 11.12% of the weight of the Index, and the five highest weighted securities accounted for 29.76% of the weight of the Index. Fourth, the selection and maintenance criteria for the Index's components should serve to ensure that the Index maintains its broad representative sample of stocks.

The Commission also believes that the general broad diversification, capitalizations, liquidity, and relative weighting of the Index's component securities minimize the potential for manipulation of the Index. First, the Index is comprised of approximately 3,400 securities listed and traded on Nasdaq, and no single security dominates the Index. Second, as of July 31, 2003, the total Index capitalization

²⁸ The option listing standards, which are uniform among the U.S. options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) the public float must be at least 7 million shares; (2) there must be a minimum of 2,000 holders of the underlying security; (3) trading volume must have been at least 2.4 million shares over the preceding 12 months; and (4) the market price per share must meet specified levels. See, e.g., PHLX Rule 1009, "Criteria for Underlying Securities," Commentary .01.

²⁹ For companies that list American Depository Shares, these values represent only the value of the outstanding American Depository Shares and not the global market capitalization of the issuer, which is the basis for listing on Nasdaq. Nasdaq's minimum listing and maintenance standard for global market capitalization is \$50 million. See note 12 *supra*.

²⁴ See PHLX Rule 511(b)(ii). According to PHLX, it may condition the allocation of an options book on the specialist's undertaking to pay the Exchange and/or any third party any amounts related to the licensing of the product or any amounts related to the use of intellectual property.

²⁵ 15 U.S.C. 78f(b)(5). In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).