

was \$2.6 trillion, the median capitalization of the Index's components was \$110 million, the capitalizations of the Index's ten most heavily weighted components (representing 37.68% of the weight of the Index) ranged from approximately \$32 billion to approximately \$284 billion, and only 2.56% of the capitalization of the Index was comprised of securities with a market capitalization of less than \$100 million. Third, during the period from January 1, 2003, through July 31, 2003, the average daily trading volume of the component securities representing 95% of the weight of the Index was 850,000 shares and only 2.19% of the capitalization of the Index was comprised of components with an average daily trading volume of less than 10,000 shares. Fourth, as of July 31, 2003, component securities representing 95% of the weight of the Index were options eligible.<sup>30</sup> Fifth, the PHLX has represented that it will monitor the Index on a semi-annual basis and will notify Commission staff if and when: (1) 10% of the capitalization of the Index comprises securities with a market capitalization of less than \$100 million; (2) 10% of the capitalization of the Index is made up of components with an average daily trading volume of less than 10,000 shares over the previous six months; (3) less than 80% of the weight of the Index is options eligible; (4) 10% of the weight of the index is represented by securities trading less than 20,000 shares per day; or (5) the largest component of the Index comprises 15% of the weight of the Index, or the top five components comprise 50% of the weight of the Index.<sup>31</sup> In the event the Index fails to satisfy any of these criteria, the PHLX will notify the Commission to determine the appropriate regulatory response.<sup>32</sup>

The Commission believes that these factors minimize the potential for manipulation because it is unlikely that attempted manipulations of the prices of the Index's components would affect significantly the Index's value. Moreover, the surveillance procedures discussed below should detect as well as deter potential manipulations and other trading abuses.

Finally, the Commission believes that the position and exercise limits for the

Index Options are designed to minimize the potential for manipulation and other market impact concerns. The position and exercise limits for the Index Options are comparable to the position and exercise limits approved for other broad-based index options.<sup>33</sup>

#### 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 Index Options, 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 risks of options trading are engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because the Index Options, including FLEX Index Options and Mini-Flex Index Options, will be subject to the same regulatory regime as the other standardized options traded currently on the PHLX, the Commission believes that adequate safeguards are in place to ensure the protection of investors in Index Options.<sup>34</sup>

The Commission generally believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the market(s) trading the stocks underlying the derivative product is an important measure for the surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation. In this regard, the PHLX and the National Association of Securities Dealers, Inc. ("NASD") are members of the ISG and the ISG Agreement will

apply to the trading of Index Options.<sup>35</sup> In addition, the PHLX will apply to the Index Options the same surveillance procedures it uses currently for existing index options trading on the PHLX.

#### D. Market Impact

The Commission believes that the listing and trading of Index Options will not adversely impact the underlying securities markets.<sup>36</sup> First, the Index is broad-based and comprised of approximately 3,400 securities, no one of which dominates the Index. Second, as described above, the Index components representing a significant portion of the weight of the Index are highly capitalized and actively traded. Third, the position and exercise limits should serve to minimize potential manipulation and market impact concerns. Fourth, the risk to investors of contra-party non-performance will be minimized because the Index Options, like other standardized options traded in the U.S., will be issued and guaranteed by the Options Clearing Corporation ("OCC"). Fifth, existing PHLX index options rules and surveillance procedures will apply to the Index Options.

The Commission also believes that settling expiring Full-Size Options and Mini Index Options based on the opening prices of component securities is reasonable and consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than on closing prices may help to reduce adverse effects on markets for securities underlying Full-Size Index Options and Mini Index Options.<sup>37</sup>

#### E. FLEX Index Options and Mini-Flex Index Options

The Commission believes that the listing and trading of FLEX Index Options and Mini-Flex Index Options

<sup>35</sup> The ISG was formed on July 14, 1983, to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. All of the registered national securities exchanges and the NASD are members of the ISG. In addition, futures exchanges and non-U.S. exchanges and associations are affiliate members of ISG. As noted above, the PHLX represents that Index component securities comprising only 0.64% of the weight of the Index are incorporated in countries where the domestic equity exchange is not a member of the ISG.

<sup>36</sup> As noted above, both the PHLX and OPRA have represented that they have the necessary systems capacity to support the new series of index options that would result from the introduction of the Index Options. See notes 16 and 17, *supra*, and accompanying text.

<sup>37</sup> See, e.g., Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (order approving File No. SR-CBOE-92-09) ("1992 Order").

<sup>30</sup> See note 28 *supra* for a description of the PHLX's options eligibility standards.

<sup>31</sup> See Amendment No. 3, note 4 *supra*.

<sup>32</sup> If the composition of the Index's underlying securities were to change substantially, the Commission's decision regarding the appropriateness of the Index's current maintenance standards would be reevaluated, and additional approval under Section 19(b) of the Act might be necessary to continue to trade the Index Options.

<sup>33</sup> See, e.g., Securities Exchange Act Release No. 48591 (October 2, 2003), 68 FR 58728 (October 10, 2003) (File No. SR-CBOE-2003-17) (approving options on 11 broad-based Russell Indexes, with position limits for each index option of 50,000 contracts on either side of the market and no more than 30,000 contracts in the series in the nearest expiration month).

<sup>34</sup> The Commission previously has designated FLEX index options as standardized options for the purposes of the options disclosure framework established under Rule 9b-1 of the Act. See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993) (File Nos. SR-CBOE-92-17; SR-OCC-92-33; ODD-93-1).