

such position is hedged and if so, a description of the hedge and if applicable, the collateral used to carry the position. Exchange market-makers (including DPMs) would continue to be exempt from this reporting requirement as market-maker information can be accessed through the Exchange's market surveillance systems. In addition, the general reporting requirement for customer accounts that maintain a position in excess of 200 contracts will remain at this level for DIA options.⁵

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁶ and, in particular, the requirements of section 6 of the Act⁷ and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with section 6(b)(5) of the Act⁸ because it is designed to promote just and equitable principles of trade, to remove impediments to, and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In the past, the Commission has stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.⁹

In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing concerns when considering the

appropriate level at which to set position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the component securities comprising an index. These same concerns exist for the underlying portfolio securities held by exchange-traded fund shares, which track indexes such as the DIA. At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market makers from adequately meeting their obligations to maintain a fair and orderly market.¹⁰

The Commission has carefully considered the CBOE's proposal to increase position and exercise limits for DIA options. At the outset, the Commission notes that it still believes the fundamental purpose of position and exercise limits are being served by their existence. However, given the surveillance capabilities of the Exchange and the depth and liquidity in both the DIA options and the underlying cash market in DIAs, the Commission believes it is permissible to significantly raise position and exercise limits for DIA options without risk of disruption to the options or underlying cash markets. Specifically, the Commission believes that it is appropriate to increase position and exercise limits from 75,000 contracts to 300,000 contracts for DIA options for several reasons.

First, the Commission believes that the structure of the DIA options and the considerable liquidity of both the underlying cash and options market for DIA options lessen the opportunity for manipulation of this product and disruption in the underlying market that a lower position limit may protect against. In this regard, the CBOE notes that DIA, based on the Dow Jones Industrial Average, is among the most actively traded exchange-traded funds, averaging 4.5 million shares per day during the first six months of 2002. Moreover, the components comprising the fund are themselves among the most actively traded and widely held securities listed in the U.S. These factors provide support for higher limits for the DIA options and differentiate them from other equity options (including options on other exchange-traded fund shares).

Second, the Commission notes that current margin and risk-based haircut methodologies serve to limit the size of

positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. Further, the CBOE, under CBOE Rules 4.13 and 12.10, may impose additional margin on options positions if it determines that this is warranted. The Commission believes that these financial requirements should help to address concerns that a member or its customer may try to maintain an inordinately large unhedged position in DIA options and will help to reduce risks if such a position is established.

Finally, the Commission believes that the reporting requirements imposed by the Exchange under CBOE Rule 4.13 will help protect against potential manipulation. The Exchange will require that each member or member organization that maintains a position on the same side of the market in excess of 10,000 contracts in the DIA option class, for its own account or for the account of a customer report certain information. This data would include, but would not be limited to, the option position, whether such position is hedged and if so, a description of the hedge and if applicable, the collateral used to carry the position. Exchange market-makers (including DPMs) would continue to be exempt from this reporting requirement as market-maker information can be accessed through the Exchange's market surveillance systems. In addition, the general reporting requirement for customer accounts that maintain a position in excess of 200 contracts will remain at this level for DIA options.¹¹ This information should help the CBOE to monitor accounts and determine whether it is necessary to impose additional margin for under-hedged positions, as provided under its rules.

In summary, the financial and reporting requirements noted above should allow the Exchange to detect and deter trading abuses arising from the increased position and exercise limits, and will also allow the Exchange to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if deemed necessary. These requirements, coupled with the special trading characteristics of the DIA options and the underlying DIA noted above, warrant approval of the Exchange's proposal.¹²

¹¹ See CBOE Rule 4.13(a).

¹² Of course, the Commission expects that CBOE will take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in the

⁵ See CBOE Rule 4.13(a).

⁶ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁷ 15 U.S.C. 78f.

⁸ 15 U.S.C. 78f(b)(5).

⁹ See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998).

¹⁰ *Id.*