Commission notes that the original proposal, which was published for the full comment period, elicited no public comment. Accordingly, the Commission believes that there is good cause, consistent with Section 19(b)(2) of the Act,[25] to approve Amendment No. 3 to the PCX's proposed rule change on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR–PCX–2003–24. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the PCX. All submissions should refer to File No. SR–PCX–2003–24 and should be submitted by [insert date 21 days from date of publication].

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[26] that the proposed rule change, (File No. SR–PCX–2003–24), as amended by Amendments No. 1 and 2, is approved, and Amendment No. 3 is approved on an accelerated basis.

[25] 15 U.S.C. 78s(b)(2).

[26] *Id.*

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[27]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–30838 Filed 12–12–03; 8:45 am]

BILLING CODE 8010–01–P

[27] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48884; File No. SR–PHLX–2003–66]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 and Notice of Filing Order Granting Accelerated Approval to Amendment No. 3 by the Philadelphia Stock Exchange, Inc., Relating to the Listing and Trading of Options on the Nasdaq Composite Index®

December 5, 2003.

I. Introduction

On September 29, 2003, the Philadelphia Stock Exchange, Inc. (''PHLX'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposal to list and trade cash-settled, European-style options on the Nasdaq Composite Index® (the ''Nasdaq Composite Index'' or ''Index''), a capitalization-weighted, A.M.-settled index comprised of approximately 3,400 stocks listed and traded on The Nasdaq Stock Market, Inc. (''Nasdaq''). The PHLX filed Amendment Nos. 1 and 2 to the proposal on October 17, 2003.[3] and filed Amendment No. 3 to the proposal on November 13, 2003.[4]

The proposed rule change and Amendment Nos. 1 and 2 were published for comment in the **Federal Register** on October 24, 2003.[5] The Commission received two comment letters regarding the proposal.[6] On November 21, 2003, the PHLX submitted a letter responding to the issues raised in the comment letters.[7] This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments on and is simultaneously approving, on an accelerated basis, Amendment No. 3.

II. Description of the Proposal

The PHLX proposes to list and trade cash-settled options on the Index. In addition trading full-size options on the Index (''Full-Size Index Options''), the PHLX proposes to trade mini Index options that are 1⁄10th the size of Full-Size Index Options (''Mini Index Options''), Flexible Exchange Index (''FLEX®'') options on the Index (''FLEX Index Options''), and mini-FLEX Index Options (''Mini-Flex Index Options'') (the Full-Size Index Options, Mini Index Options, FLEX Index Options, and Mini-Flex Index Options may be referred to, collectively, as the ''Index Options'').[8] The PHLX will trade the Index Options pursuant to current PHLX rules governing the trading of index options.[9] The PHLX's current rules applicable to the trading of FLEX index options, including the requirement that the minimum size of a Request-for-Quote (''RFQ'') be $10

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* letter from Mark I. Salvacion, Director and Counsel, PHLX, to Kelly Riley, Senior Special Counsel, Division of Market Regulation (''Division''), Commission, dated October 17, 2003 (''Amendment No. 1''); and letter from Mark I. Salvacion, Director and Counsel, PHLX, to Yvonne Fraticelli, Special Counsel, Division, Commission, dated October 17, 2003 (''Amendment No. 2''). In Amendments No. 1, the PHLX revises the position and exercise limits for the proposed options. In Amendments No. 2, the PHLX proposes to list mini-FLEX options on the Nasdaq Composite Index and provides an example of how the proposed mini-FLEX options could be used.

[4] *See* letter from Mark I. Salvacion, Director and Counsel, PHLX, to Kelly Riley, Senior Special Counsel, Division. Commission, dated November 12, 2003 (''Amendment No. 3''). In Amendment No. 3, the PHLX represents that the PHLX will notify the staff of the Commission if: (1) Less than 80% of the weight of the Index is options eligible; (2) 10% of the weight of the Index is represented by stocks trading less than 20,000 shares per day; or (3) 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.

[5] *See* Securities Exchange Act Release No. 48663 (October 20, 2003), 68 FR 61029.

[6] *See* letter from Kathryn L. Beck, Senior Vice President, General Counsel, Corporate Secretary, and Chief Regulatory Officer, Pacific Exchange, Inc. (''PCX''), to Margaret H. McFarland, Deputy Secretary, Commission, dated October 24, 2003 (''PCX Letter''); and letter from Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange, Inc. (''ISE''), to Jonathan G. Katz, Secretary, Commission, dated November 10, 2003 (''ISE Letter'').

[7] *See* letter from Mark Salvacion, Director and Counsel, PHLX, to Kelly Riley, Senior Special Counsel, Division, Commission, dated November 21, 2003 (''PHLX Letter'').

[8] The Full-Size Index Options and the Mini Index Options will feature European-style exercise. The FLEX Index Options and the Mini-Flex Index Options may feature American-style exercise or European-style exercise. *See* PHLX Rule 1079(a)(5).

[9] *See*, particularly, PHLX Rules 1000A through 1102A (Rules Applicable to Trading of Options on Indices) and, generally, PHLX Rules 1000 through 1090 (Options Rules of the PHLX).

million, will apply to Mini-Flex Index Options.[10]

Composition of the Index

The Index is a capitalization-weighted index comprised of approximately 3,400 stocks listed and traded on Nasdaq. The Index includes Nasdaq National Market and Nasdaq SmallCap Market securities. To be eligible for inclusion in the Index, a security must be listed on Nasdaq and must be one of the following types of securities: an American Depositary Receipt (''ADR''), common stock, ordinary share, real estate investment trust (''REIT''), share of beneficial interest, of tracking stock. The Index is comprised of all of the foreign and domestic ADRs, common stocks, ordinary shares, REITs, shares of beneficial interest, and tracking stocks listed on Nasdaq. Convertible debentures, preferred stocks, rights, warrants, units, closed-end funds, exchange-traded funds (''ETFs''), and derivative securities are not included in the Index.

The Index includes most of the stocks listed and traded on the Nasdaq SmallCap Market. Nasdaq SmallCap Market securities are ''reported securities'' for purposes of Rule 11Aa3–1 under the Act.[11] According to the PHLX, Nasdaq SmallCap Market stocks comprised 1.3% of the capitalization of the Index as of July 31, 2003.

The Index includes ten industry groups. As of July 31, 2003, the top five industry groups and their weights in the Index were: (1) computer software and hardware, 52%; (2) healthcare, 14%; (3) financials, 11%; (4) consumer discretionary, 8%; and (5) telecommunications and media, 6%.

As of July 31, 2003, the capitalization of the Index's components ranged from $284 billion to $55,000,[12] and the market capitalization of the Index totaled $2.6 trillion. The largest Index component accounted for 11.12% of the weight of the Index and the smallest component accounted for less than 1% of the weight of the Index. The median capitalization of the Index's components was $110 million.

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 the average daily trading volume for all of the Index's components was 485,000 shares. The top 100 components accounted for 64% of the weight of the Index and the bottom 100 stocks accounted for 0.01% of the weight of the Index. The prices of the Index's components ranged from $0.11 per share to $780.00 per share. The average share price was $14.15. The share outstanding for each of the Index's components ranged from 10,000 shares to 11 billion shares, with an average of 43 million shares outstanding. According to the PHLX, options eligible securities represented 95% of the weight of the Index.

Calculation of the Index

The value of the Index equals the aggregate value of the Total Shares Outstanding (''TSO'') of each Index component security multiplied by each security's respective price on Nasdaq, divided by the Adjusted Base Period Market (''ABPMV''), and multiplied by the Base Value. The Index began on February 5, 1971, at a Base Value of 100.00.

The Index is disseminated every 15 seconds through the Nasdaq Index Dissemination Services℠ (''NIDS'') during normal Nasdaq trading hours (9:30 a.m. to 4:00 p.m. ET).[13] According to the PHLX, all major market data vendors carry the NIDS data feed.

The Index is calculated using Nasdaq prices (not consolidated) during the day and the Nasdaq Official Closing Price (''NOCP'') for the close.[14] Although the Index is calculated until 4:00 p.m. ET, the Index's closing value may change up until 5:15 p.m. ET due to changes or corrections to the last sale in the Index's component securities.

Maintenance

Nasdaq will maintain the Index, and the PHLX represented that it will not influence any Nasdaq decisions concerning maintenance of the Index.

An Index-eligible security (either an initial public offering or a seasoned security) is added to the Index on the business day immediately after a last sale is established (usually day two of listing on Nasdaq). A component security that is no longer traded on Nasdaq or no longer meets the security-type eligibility criteria is removed from the Index. The Index is updated on a daily basis and there is no periodic rebalancing of Index components.

Changes in the number of shares outstanding driven by corporate events, including stock dividends, splits, and certain spin-offs and rights issuances are adjusted on the ex-date. A change in the TSO arising from other corporate actions including secondary offerings, stock repurchases, conversions, and acquisitions is ordinarily made to the Index on the evening prior to the effective date of the corporate action or as soon as practicable thereafter. Changes are made after the market close and are reflected on *http://www.nasdaqtrader.com/asp/nasdaqcomp.asp* the following morning.

To ensure that there is no discontinuity in the value of the Index, Nasdaq ordinarily adjusts the ABPMV when there is a change in a component security's TSO, a component addition or deletion, or changes due to certain spin-offs and rights offerings.

Although the PHLX is not involved in the maintenance of the Index, it 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 stocks 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.[15] According to the PHLX, as of July 31, 2003, component securities representing 2.56% of the capitalization of the Index had market capitalizations

[10] Telephone conversation between Kelly Riley, Senior Special Counsel, Division, Commission, and Mark Salvacion, Director and Counsel, PHLX, on November 25, 2003.

[11] *See* 17 CFR 240.11Aa3–1. A ''reported security'' is defined in Rule 11Aa3–1(a)(4) under the Act as ''any listed equity security or Nasdaq security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan.'' In 2001, the Commission approved the extension of the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis (''Nasdaq UTP Plan'') to include Nasdaq SmallCap Market securities. Accordingly, Nasdaq SmallCap Market securities became securities reported pursuant to an effective transaction reporting plan approved by the Commission.

[12] For companies that list American Depositary Shares, these values represent only the value of the outstanding American Depositary 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.

[13] NIDS is a Nasdaq data feed carrying intra-day index values and valuation data for ETFs listed on Nasdaq.

[14] *See* Securities Exchange Act Release No. 47517 (March 18, 2003), 68 FR 14446 (March 25, 2003) (File No. SR–NASD–2002–158) (approving the establishment of the NOCP).

[15] *See* Amendment No. 3, note 4 *supra.*

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 letters [19] 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.*

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 exclusing licensing agreement provides no incentive for the PHLX to inflate trading volumes artifically.

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 flexiblity 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 PHLIX 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 segement 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

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[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).

[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 outweighted 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.

[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.*

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.[30] 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.[31] In the event the Index fails to satisfy any of these criteria, the PHLX will notify the Commission to determine the appropriate regulatory response.[32]

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.[33]

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.[34]

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.[35] 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.[36] 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.[37]

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

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[30] *See* note 28 *supra* for a description of the PHLX's options eligibility standards.

[31] *See* Amendment No. 3, note 4 *supra.*

[32] 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.

[33] *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).

[34] 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).

[35] 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.

[36] 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.

[37] *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'').

should provide investors with more tailored options on the Index and extend to investors the benefits of a listed, exchange market in customized index options.[38] The benefits of the PHLX's options market include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, parameters and procedures for clearance and settlement, and the guarantee of OCC for all contracts traded on the PHLX. In addition, the Commission believes that the proposal to list and trade FLEX Index Options and Mini-Flex Index Options could help the PHLX to compete with the over-the-counter (''OTC'') market in customized index options and help the PHLX to meet the demands of portfolio managers and other institutional investors who may use the OTC market to meet their hedging needs. The Commission notes that the PHLX rules governing the trading of FLEX index options, including the minimum size requirement for an RFQ, will apply to Mini-Flex Index Options.[39]

Under the PHLX's rules, FLEX Index Options and Mini-Flex Index Options can be constructed with expiration exercise settlement based on the closing values of the Index's component securities, which potentially could result in adverse effects for the markets in these securities.[40] Although the Commission continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Friday helps to alleviate stock market volatility,[41] these market impact concerns are reduced in the case of FLEX Index Options and Mini-Flex Index Options because the expiration of these options will not correspond to the normal expiration of any non-FLEX options (including options overlying the Index), stock index futures, and options on stock index futures. In particular, FLEX options may never expire on any ''Expiration Friday'' because under the PHLX's rules the expiration date of a FLEX option may not occur on a day that is on, or within, two business days of the expiration date of a non-FLEX option.[42] The Commission believes that this should reduce the possibility that the exercise of FLEX Index Options or Mini-Flex Index Options at expiration will cause any additional pressure on the market for the underlying securities at the same time non-FLEX Index Options expire.

F. Exclusive Licensing Agreement

As noted above, both commenters raised concerns about the PHLX's exclusive licensing agreement with Nasdaq to trade the Index Options. The Commission notes that the ISE has filed a petition for rulemaking to amend Rule 19c–5 under the Act[43] to prohibit options exchanges from entering into exclusive licensing agreements with respect to index option products.[44] The Commission believes that the issues raised by the commenters and by ISE in its petition for rulemaking regarding the exclusive licensing of index option products should be considered comprehensively rather than on an *ad hoc* basis in the context of a particular index option product or products, such as the Index Options. In addition, the Commission believes that investors will benefit from the availability of the Index Options because, as described above, they will provide investors with additional hedging and trading vehicles. Accordingly, the Commission believes that it is appropriate in the public interest to approve the current proposal in order to make the Index Options available to investors while the Commission considers the issues presented by the exclusive licensing of index option products in the context of the ISE's petition for rulemaking.

G. Accelerated Approval of Amendment No. 3

The Commission finds good cause to approve Amendment No. 3 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 3 strengthens the proposal by representing that the PHLX will notify the Commission staff upon the occurrence of certain changes in the Index. Accordingly, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b)(2) of the Act,[45] to approve Amendment 3 on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. SR–PHLX–2003–66. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, your comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PHLX. All submissions should refer to File No. SR–PHLX–2003–66 and should be submitted by January 5, 2004.

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[46] that Amendment No. 3 be approved on an accelerated basis and that the proposed rule change (SR–PHLX–2003–66), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[47]

Margaret H. McFarland,

Deputy Secretary.

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SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster #3555, Amdt. 3]

State of California

In accordance with a notice received from the Department of Homeland Security—Federal Emergency Management Agency, effective December 2, 2003, the above numbered declaration is hereby amended to establish the incident period for this disaster as beginning October 21, 2003 and continuing through December 2, 2003.

[38] FLEX options allow investors to customize certain terms, including size, term to expiration, exercise style, exercise price, and exercise settlement value.

[39] *See* note 10 *supra* and accompanying text.

[40] *See* 1992 Order.

[41] *See* 1992 Order.

[42] *See* PHLX Rule 1079(a)(6).

[43] 17 CFR 240.19c–5.

[44] *See* letter from David Krell, President and Chief Executive Officer, ISE, to Jonathan Katz, Secretary, Commission, dated November 1, 2002.

[45] 15 U.S.C. 78f(b)(5) and 78s(b)(2).

[46] 15 U.S.C. 78s(b)(2).

[47] 17 CFR 200.30–3(a)(12).