

II. Description of Proposal

A. General

The CBOE proposes to list for trading options on the Automotive Index, a new securities index developed by the CBOE. The Automotive Index consists of ten companies involved in the design and manufacture of automobiles and automotive parts (replacement and original equipment).⁵ The CBOE also proposes to list either long-term options on the full-value Index or long-term options on a reduced-value Index that will be computed at one-tenth of the value of the Automotive Index ("Automotive Index LEAPS" or "Index LEAPS").⁶ Automotive Index LEAPS will trade independent of and in addition to regular Index options traded on the Exchange,⁷ however, as discussed below, for purposes of position and exercise limits, positions in Index LEAPS and regular Index options will be aggregated.

B. Composition of the Index

The Index was designed by the Exchange and is comprised of ten companies involved in the design and manufacture of automobiles and automotive parts. The share of each of the components contained in the Index currently trade in the U.S. on the New York Stock Exchange ("NYSE").

As of the close of trading on July 31, 1995, the Index was valued at 179.93. As of the same date, the components comprising the Index ranged in capitalization from \$2.3 billion to \$36.4 billion. The total capitalization as of that date was \$112.2 billion; the mean capitalization was \$11.2 billion; and the median capitalization was \$4.8 billion. The largest component accounted for 20% of the total weighting of the Index, while the smallest accounted for 5.00%. The top five components accounted for 68.33% of the total weight of the Index.⁸

Division of Market Regulation ("Market Regulation"), Commission, dated December 14, 1995 ("Amendment No. 1").

⁵ The components of the Index are: Chrysler Corporation Holding Co. ("C"); Dana Corp. ("DCN"); Echlin Inc. ("ECH"); Eaton Corp. ("ETN"); Ford Motor Co. ("F"); General Motors Corp. ("GM"); Genuine Parts Co. ("GPC"); Goodyear Tire and Rubber Co. ("GT"); Magna International Inc. ("MGA"); and TRW Inc. ("TRW").

⁶ LEAPS is an acronym for Long-Term Equity Anticipation Securities. LEAPS are long-term index option series that expire from 12 to 36 months from their date of issuance. See CBOE Rule 24.9(b)(1).

⁷ According to the CBOE, no proxy for the performance of this industry group is currently available in the U.S. exchange-traded derivatives markets, and the Exchange believes that options on the Index will provide investors with a low-cost means to participate in the performance of or to hedge the risk of investments in this sector.

⁸ The Index portfolio is composed of ten components such that the largest capitalized Index

The average trading volume of the components of the Index, for the period from February 1, 1995, through July 31, 1995, ranged from a high of 3.53 million shares per day to a low of 135,738 shares per day.

C. Maintenance

The Index will be maintained by CBOE. To maintain continuity in the Index following an adjustment to a component security, the divisor will be adjusted. Changes which may result in divisor changes include, but are not limited to, certain rights issuances, quarterly re-balancing, and component security changes. A component of the Index may be replaced in the event of certain events, such as a merger, consolidation, dissolution, or liquidation.

The Index is re-balanced after the close of business on Expiration Friday on the March Quarterly Cycle. In addition, the Index will be reviewed on approximately a monthly basis by the CBOE staff. The CBOE may change the composition of the Index at any time to reflect changes affecting the components of the Index or the Automotive industry generally. If it becomes necessary to remove a component from the Index, every effort will be made to add a component that preserves the character of the Index. Moreover, replacement securities must be "reported securities" as defined in Rule 11Aa3-1 of the Act.⁹ In considering securities to be added to the Index, the CBOE will take into account the capitalization, liquidity, volatility, and name recognition of the proposed replacement component. CBOE will not decrease the number of components to less than 9 nor increase the number of components to more than 13.

If the number of stocks is increased, the weights will be redistributed such that the largest stock will never account for more than 25% of the weight of the Index and the top three stocks will not account for more than 50% of the weight of the Index and the remaining weight will be distributed among the remaining components to reflect the relative market value of those components. For example, if Stock XYZ is added and it is in the same market value range as those stocks with an 8.33% weight in the Index,¹⁰ the

component (GM) represents 20% of the Index value, the second largest component (F) represents 17.5%, the third largest component (C) represents 12.5%, the fourth largest component (GT) represents 10%, the fifth (GT), sixth (TRW), and seventh (GPC) largest components each represent 8.33%, and the eighth (DCN), ninth (ECH), and tenth (MGA) largest components each represent 5%.

⁹ See Amendment No. 1, *supra* note 4.

¹⁰ See *supra* note 8.

following may be the result of the re-balancing: (1) GM—20%; (2) F—17.5%; (3) C—12.5%; (4) GT—10%; (5) TRW—6.25%; (6) GPC—6.25%; (7) ETN—6.25%; (8) XYZ—6.25%; (9) DCN—5%; (10) ECH—5%; and (11) MGA—5%.

If the number of stocks in the Index is decreased to 9, the largest stock will have a weight of no more than 25% of the Index and the top three stocks will account for no more than 55% of the Index. The remaining weight will be reallocated among the remaining components.

If it becomes necessary to replace a component security intra-quarter, the replacement security will be added at the same weight as the security being removed.¹¹ If a stock is replaced at the time of a quarterly re-balancing, the components will be ranked according to market value and the weighting methodology currently in use at the time of the replacement will be applied.¹² The number of component stocks in the Index will only be changed at the time of a quarterly re-balancing.

Prior to making any of the above changes to the Automotive Index, CBOE will notify members and member firms of the changes. Generally, these changes are sent by facsimile to member firms and distributed on the trading floor approximately one week prior to the change.¹³

Additionally, at each quarterly re-balancing, the Exchange will ensure that at least 80% of the number of components, and at least 90% of the weight of the Index satisfies the initial listing criteria in CBOE Rule 5.3¹⁴ (for components which are not the subject of

¹¹ In the event that it becomes necessary to remove General Motors Corp., Ford Motor Co., or Chrysler Corporation, CBOE would most likely re-balance the Index at the time of the component change. The weighting of the Index would be reallocated depending on the market value of the replacement security. See Amendment No. 1, *supra* note 4.

¹² See Amendment No. 1, *supra* note 4. According to CBOE, the Index components will always be ranked in descending market capitalization order and the Index portfolio adjusted in accordance with the maintenance standards set forth herein. Telephone conversation between Eileen Smith, Director, Product Development, Research Department, CBOE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on December 14, 1995.

¹³ See Amendment No. 1, *supra* note 4.

¹⁴ The CBOE's options listing standards, which are uniform among the 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 7,000,000 shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume in the U.S. must have been at least 2.4 million over the preceding twelve months; and (4) the U.S. market price must have been at least \$7.50 for a majority of the business days during the preceding three calendar months. See CBOE Rule 5.3, Interpretation and Policy .01.