SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49696; File No. SR-ISE-2004-08)

May 13, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by International Securities Exchange, Inc., Relating to Trading Options on the S&P MidCap 400 Index

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on March 2, 2004, the International Securities Exchange, Inc. ("Exchange" or "ISE") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which items have been prepared by the Exchange. ISE amended its proposal on April 19, 2004.[3] The proposal was also amended by ISE on May 13, 2004.[4] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and is approving the proposal on an accelerated basis.

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

2 17 CFR 240.19b-4.

3 See letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated April 16, 2004 ("Amendment No. 1"). In Amendment No. 1, the ISE made technical corrections to its rule text.

4 See letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division, Commission, dated May 13, 2004 ("Amendment No. 2"). In Amendment No. 2, the ISE provided additional information on the Standard & Poor's MidCap 400 Index ("S&P MidCap 400" or "Index") and added two exhibits to the proposed rule change. The first exhibit is a letter from the Options Price Reporting Authority stating that it has the capacity to support the trading of options on the Index on the Exchange. The second exhibit is a document that sets forth Standard & Poor's criteria for inclusion or exclusion of components in the Index.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is proposing to amend its rules to trade options on the Index. The text of the proposed rule change, as amended, appears below. Additions are italicized; deletions are in [brackets].

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Rule 2001. Definitions

((a) – (m) no change)

Supplementary Material to Rule 2001

.01 The reporting authorities designated by the Exchange in respect of each index underlying an index options contract traded on the Exchange are as provided in the chart below.

Underlying Index	Reporting Authority
S&P SmallCap 600 Index	Standard & Poor's
Morgan Stanley Technology Index	American Stock Exchange
S&P MidCap 400 Index	Standard & Poor's

Rule 2004. Position Limits for Broad-Based Index Options

(a) Rule 412 generally shall govern position limits for broad-based index options, as modified by this Rule 2004. There may be no position limit for certain Specified (as provided in Rule 2000) broad-based index options contracts. All other broad-based index options contracts shall be subject to a contract limitation fixed by the Exchange, which shall not be larger than the limits provided in the chart below.

Broad-Based Underlying Index	Standard Limit (on the same side of the market)	Restrictions

S&P SmallCap 600 Index	100,000 contracts	No more than 60,000 near-term
S&P MidCap 400 Index	45,000 contracts	No more than 25,000 near-term

((b) – (c) no change)

Rule 2009. Terms of Index Options Contracts

((a)(1) – (3) no change)

(4) "European-Style Exercise." The following European-style index options, some of which may be A.M.-settled as provided in paragraph (a)(5), are approved for trading on the Exchange:

(i) S&P SmallCap 600 Index[.]

(ii) Morgan Stanley Technology Index

(iii) S&P MidCap 400 Index

(5) A.M.-Settled Index Options. The last day of trading for A.M.-settled index options shall be the business day preceding the last day of trading in the underlying securities prior to expiration. The current index value at the expiration of an A.M.-settled index option shall be determined, for all purposes under these Rules and the Rules of the Clearing Corporation, on the last day of trading in the underlying securities prior to expiration, by reference to the reported level of such index as derived from first reported sale (opening) prices of the underlying securities on such day, except that:

(i) In the event that the primary market for an underlying security does not open for trading on that day, the price of that security shall be determined, for the purposes of calculating the current index value at expiration, as set forth in Rule 2008(g), unless the current index value at expiration is fixed in accordance with the Rules and By-Laws of the Clearing Corporation; and

(ii) In the event that the primary market for an underlying security is open for trading on that day, but that particular security does not open for trading on that day, the price of that security, for the purposes of calculating the current index value at expiration, shall be the last reported sale price of the security.

The following A.M.-settled index options are approved for trading on the Exchange:

(i) S&P SmallCap 600 Index

(ii) Morgan Stanley Technology Index

<u>(iii) S&P MidCap 400 Index</u>

(b) Long-Term Index Options Series.

((1)(i) and (ii) no change)

(2) Reduced Value Long Term Options Series.

(i) Reduced-value long term options series on the following stock indices are approved for trading on the Exchange:

(A) S&P SmallCap 600 Index

(B) Morgan Stanley Technology Index

(C) <u>S&P MidCap 400 Index</u>

(ii) Expiration Months. Reduced-value long term options series may expire at six-month intervals. When a new expiration month is listed, series may be near or bracketing the current index value. Additional series may be added when the value of the underlying index increases or decreases by ten (10) to fifteen (15) percent.

(c) Procedures for Adding and Deleting Strike Prices. The procedures for adding and deleting strike prices for index options are provided in Rule 504, as amended by the following:

(1) The interval between strike prices will be no less than $5.00; provided, that in the case of the following classes of index options, the interval between strike prices will be no less than $2.50:

(i) S&P SmallCap 600, if the strike price is less then $200.00[.]

(ii) Morgan Stanley Technology Index, if the strike price is less then $200.00

(iii) <u>S&P MidCap 400 Index, if the strike price is less then $200.00</u>

((c)(2) – (e) no change)

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II. <u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>

In its filing with the Commission, the ISE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change, as amended. The text of these statements may be examined at the places specified in Item III below. The ISE has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

A. <u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>

1. <u>Purpose</u>

The ISE proposes to amend its rules to provide for the listing and trading on the Exchange of cash-settled, European-style index options and LEAPS, including reduced value LEAPS, on the S&P MidCap 400. Options on the Index are currently trading on the American Stock Exchange LLC (“Amex”).[5] ISE states that the proposed rule changes adopt the same

[5] <u>See</u> Exchange Act Release No. 30290 (February 3, 1992) (order approving Amex to trade options on the S&P MidCap 400 Index, hereinafter the “1992 Order”).

standards and product specifications that are currently applied for options traded on the S&P MidCap 400 on Amex.

Index Design and Composition

The S&P MidCap 400 Index measures the performance of the mid-range sector of the U.S. stock market. The Index is based on 400 stocks chosen on the basis of market capitalization, liquidity, and industry group representation. The Index is market value (capitalization) weighted.[6] The Index was introduced on June 19, 1991.[7] The Index is composed of 400 domestic stocks from the ten market sectors. Following are the ten market sectors along with their respective weightings in the Index, as of February 26, 2004: Energy (5.5%); Materials (6.3%); Industrials (14.5%); Consumer Discretionary (16.3%); Consumer Staples (4.5%); Health Care (9.5%); Financials (16.5%); Information Technology (19.0%); Telecommunications Services (0.8%); and Utilities (7.3%). A complete list of the 400 component stocks in the Index is available at the Exchange, on the Amex website, and on the S&P website.

As of January 6, 2004, 286 companies in the Index are listed on the New York Stock Exchange, Inc. ("NYSE"), 112 on the National Association of Securities Dealers, Inc. ("NASD"), Automated Quotation System ("Nasdaq"), and 2 on the Amex. All Nasdaq stocks in the Index are designated as national market system securities by the NASD, meaning, among other things, that real-time last sale reports are available for these stocks. As of January 6, 2004,

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6 The calculation of a market capitalization-weighted index involves taking the summation of the product of the price of each stock in the index and the shares outstanding for each issue. In contrast, a price-weighted index involves taking the summation of the prices of the stocks in the index. (See 1992 Order.)

7 See Amex – The Standard & Poors MidCap 400 Index Option Specifications on the Amex website at: http://www.amex.com and the S&P website at: http://www.standardandpoors.com. The product specifications and the index components, as well as select data related to the components, shall be listed on the ISE website at http://www.iseoptions.com.

no one stock comprises more than 1.23% of the Index's total value, and the percentage weighting of the 5 largest components in the Index accounts for only 4.66% of the Index's value. Additionally, 344 (86%) of the 400 stocks included in the Index, representing 88.1% of the total weight of the Index, are the subject of standardized options trading, and many of the other Index component stocks are eligible for options trading (as of January 6, 2004).

As of January 6, 2004, the market capitalization of the stocks in the Index ranged from a high of $11.8 billion to a low of $336.2 million, with the mean and median being $2.4 billion and $2.1 billion, respectively. The total number of shares outstanding for the stocks in the Index ranges from a high of 471.4 million shares to a low of 9.5 million shares. The price per share of the stocks in the Index ranges from a high of $796.51 to a low of $3.55. Finally, the trading volume of the stocks in the Index ranges from a high of 11,489,282 average shares per day to a low of 7,605 average shares per day, with the median and mean being 437,107 and 724,445, respectively.

For the six-month period ending January 6, 2004, 398 of the 400 (99.5%) companies within the Index had an average daily trading volume greater than 30,000 shares per day. Those companies represent 99.25% of the market capitalization of the Index. The average daily trading volume of the 20 most heavily traded companies in the Index, representing 7.51% of the market capitalization of the Index, was 3,784,032 shares per day.

Index Calculation and Index Maintenance

The S&P MidCap 400 is calculated continuously,[8] using the last sale price for each

[8] The S&P MidCap 400 is calculated for S&P by Kinetic Information Systems. Reuters' Bridge Data Division also calculates the S&P MidCap 400, and its calculation is used in the event that the Kinetic Information Systems' calculation of the Index value is unavailable.

component stock in the Index, and is disseminated every 15 seconds throughout the trading day.[9] To calculate the Index, the sum of the market value of the stocks in the Index is divided by the base period market value (divisor), and the result is multiplied by 100. In order to provide continuity for the Index's value, the divisor is adjusted periodically to reflect such events as changes in the number of common shares outstanding for component stocks, company additions or deletions, corporate restructurings, and other capitalization changes.

The Index value for purposes of settling S&P MidCap 400 options ("Settlement Value") is calculated on the basis of opening market prices on the business day prior to the expiration date of such options ("Settlement Day").[10] The Settlement Day is normally the Friday preceding "Expiration Saturday."[11] In the event that a component security in the Index does not trade on Settlement Day, the closing price from the previous trading day is used to calculate the Settlement Value. Accordingly, trading in S&P MidCap 400 options will normally cease on the Thursday preceding an Expiration Saturday.

In order to ensure that the S&P MidCap 400 contains a representative sample of the stocks that represent the performance of the middle-capitalization segment of the market, S&P

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9 The Index is disseminated by Amex over the Consolidated Tape Association's Network B. ISE will also disseminate every fifteen seconds the Index to its members. The Index is published daily in, among other places, The Wall Street Journal ("WSJ") and The New York Times, and is available during trading hours from quotation vendors such as Reuters and Bloomberg. The Index criteria for inclusion or exclusion of components from the Index, attached as Exhibit 2, is included in a document entitled Standard & Poor's U.S. Indices: the S&P MidCap 400 and S&P SmallCap 600 dated April 8, 2004 available on the S&P website at http://www.standardandpoors.com. In particular, the Standard & Poor's requires that a component be an "operating company and not a closed-end fund, holding company, partnership, investment vehicle or royalty trust." Also, "Real Estate Investment Trusts are eligible for inclusion in [the Index]."

10 The aggregate exercise value of the option contract is calculated by multiplying the Index value by the Index multiplier, which is 100.

11 For any given expiration month, the Index Options will expire on the third Saturday of the month.

selects component securities based on the following market and economic criteria.[12] First, the company's market capitalization must be between $1 billion and $4 billion.[13] Second, the company must have adequate liquidity and reasonable price (the ratio of annual dollar value traded to market capitalization should be 0.3 or greater).[14] Third, corporate insiders must not hold stock representing more than 60% of the value of the company, and the company cannot have 50% or more of its stock held by other corporations.[15]

In addition, S&P considers industry group representation in selecting stocks for the S&P MidCap 400. Moreover, in order to avoid "overweighting" of utility and financial stocks, electric utilities and regional bank stocks are selected on the basis of their geographic representation as well as the above criteria.[16] Finally, any stocks already in the S&P 500 Stock

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12 S&P makes four major weighting adjustments during the year, usually near the end of a calendar quarter and monitors each S&P MidCap 400 component stock on a daily basis for individual weighting adjustments and for corporate actions which may have an impact on the Index. (See 1992 Order.)

13 See S&P's U.S. Indices: the S&P 500, S&P MidCap400 and S&P SmallCap 600 (November 17, 2003) on the S&P website at: http://www.standardandpoors.com.

14 The liquidity ratio is determined by dividing a company's trading volume for the previous 12 months by the average number of total common shares outstanding. For example, if a company's average monthly trading volume over the previous 12 months was 500,000, and there were 12 million shares outstanding, then the company's liquidity ratio would be 0.50. (See 1992 Order.)

15 S&P, in making the determination as to whether a company has 50% or more of its stock held by other corporations, includes in its determination investment companies with greater than 5% ownership, but does not include broker-dealers holding shares in "street name." (See 1992 Order.)

16 In addition, some potential companies are eliminated from inclusion in the S&P MidCap 400 for various reasons. For example, investment companies, such as closed-end mutual funds, are not included in the Index because their equity performance reflects the performance of a portfolio of securities rather than industry or company specific fundamentals. In addition, foreign companies are not included in the Index, except for some Canadian industrial companies which conduct a significant proportion of their business within the U.S. market and for which the majority of trading activity occurs on U.S. exchanges. Moreover, S&P excludes real estate investment companies and other investment trusts that allow investors to participate indirectly in the performance of real

Index are excluded from the S&P MidCap 400. Then, the components selected are weighted by market capitalization.[17]

The Exchange shall notify the Market Regulation Division of the Commission immediately in the event S&P determines to cease maintaining or calculating the Index. In the event the Index ceases to be maintained or calculated, the Exchange may determine not to list any additional series for trading or limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

Contract Specifications

The Exchange states that the S&P MidCap 400 is a broad-based index, as defined in ISE Rule 2001(j). The Exchange proposes that the contract specifications for Index options listed on the Exchange will be identical to the contract specifications for the Index options listed on Amex. Accordingly, Exchange rules that are applicable to the trading of options on broad-based indexes will apply to the trading of options on the Index.[18] Specifically, among others, Exchange rules governing margin requirements and trading halt procedures that are applicable to the trading of broad-based index options will apply to options traded on the Index. In addition, the Exchange shall establish position limits of 45,000 contracts on the same side of the market, provided no more than 25,000 of such contracts are in the nearest expiration month series and no more than 25,000 of such contracts are used for index arbitrage. The product specifications of the options on the Index proposed to be traded on the Exchange will be identical to the product

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assets such as commercial or residential property. Finally, S&P excludes limited partnerships because their ownership and capitalization structure exposes investors to liabilities and tax treatment not found in corporate equity securities. (See 1992 Order.)

17 Telephone Conversation between Joseph Ferraro, ISE, and Florence Harmon, Senior Special Counsel, Division, Commission, on April 15, 2004.

18 See Exchange Rules 2000 through 2012.

specifications of the options on the Index traded on Amex. Specifically, options on the Index are European-style and cash-settled. The Exchange's standard trading hours for index options (9:30 a.m. to 4:15 p.m., New York time), as set forth in ISE Rule 2008(a), will apply to Index options. Index options listed on Amex also trade from 9:30 a.m. to 4:15 p.m., New York time.

The minimum customer margin for uncovered writers shall be 100% of the market value of the option plus 15% of the aggregate Index value less any out-of-the-money amount, subject to a minimum of 100% of the market value of the option plus 10% of the aggregate Index value.

The Exchange proposes to use strike price intervals of 2 1/2 points for certain near-the-money series in near-term expiration months when the Index is at a level below 200, and 5 point strike price intervals for other options series with expirations up to one year, and 25 to 50 point strike price intervals for longer-term options. The Exchange also proposes to list S&P MidCap 400 options in the four consecutive near-term expiration months plus two successive expiration months in the March cycle. For example, consecutive expirations of January, February, March and April plus June and September expirations would be listed. In addition, longer-term option series having up to thirty-six months to expiration may be traded. In lieu of such long-term options based on the full-value of the Index, the Exchange may instead list long-term, reduced-value put and call options based on one-tenth (1/10th) of the Index's full value. In either event, the interval between expiration months for either a full-value or reduced-value long-term Index option will not be less than six months. The trading of any long-term Index options will be subject to the same rules which govern the trading of all the Exchange's index options, including sales practice rules, margin requirements, and trading rules. Position limits on reduced-value long-term Index options will be equivalent to the position limits for regular (full-value) Index options and will be aggregated with such options. For example, if the position limit for the full-value options on the Index is 45,000 contracts on the same side of the market (as they currently are on Amex), then the position limit for the reduced-value options will be 450,000 contracts on the same side of the market.

Surveillance and Capacity

The Exchange has an adequate surveillance program in place for Index options and intends to apply those same program procedures that it applies to the Exchange's other index options (at present, options on the S&P SmallCap 600 Index and Morgan Stanley Technology Index). Additionally, the Exchange is a member of the Intermarket Surveillance Group ("ISG") under the Intermarket Surveillance Group Agreement (dated June 20, 1994). The members of the ISG include all of the U.S. registered stock and options markets: the Amex, the Boston Stock Exchange, Inc. ("BSE"), the Chicago Board Options Exchange, Inc. ("CBOE"), the Chicago Stock Exchange, Inc. ("CHX"), the Cincinnati Stock Exchange, Inc. ("CSE"), the NASD, the NYSE, the Pacific Exchange, Inc. ("PSE") and the Philadelphia Stock Exchange, Inc. ("PHLX"). The ISG members work together to coordinate surveillance and investigative information sharing in the stock and options markets. In addition, the major futures exchanges are affiliated members of the ISG, which allows for the sharing of surveillance information for potential intermarket trading abuses.

The Exchange states that it has the necessary systems capacity to support new series that will result from the introduction of S&P MidCap 400 Index options. ISE has also been informed that the Options Price Reporting Authority believes that it has the capacity to support such new series.

2. Statutory Basis

The ISE believes that the proposed rule change, as amended, is consistent with and furthers the objectives of Section 6(b)(5) of the Act,[19] in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, ISE states that the proposed rule change will permit trading in options based on the S&P MidCap 400 pursuant to rules designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principals of trade.

B. Self-Regulatory Organization's Statement on Burden on Competition

The ISE does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

No written comments were solicited or received with respect to the proposed rule change, as amended.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

[19] 15 U.S.C. 78(f)(b)(5).

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-ISE-2004-08 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-ISE-2004-08. 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, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-ISE-2004-08 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Approval of the Proposed Rule Change

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 exchange, and, in particular, the requirements of Section 6(b)(5).[20] The Commission finds that the trading of options on the Index, including full-value and reduced-value Index LEAPS, will permit investors to participate in the price movements of the 400 securities on which the Index is based. The Commission also believes that the trading of options on the Index will allow investors holding positions in some or all of the underlying securities in the Index to hedge the risks associated with their portfolios more efficiently and effectively. Accordingly, the Commission believes MidCap 400 options will provide investors with an important trading and hedging mechanism that should reflect accurately the overall movement of stocks in the middle-capitalization range of U.S. equity securities.

The trading of MidCap 400 options, however, raises several issues, namely, issues related to index classification, index design, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the ISE has adequately addressed these issues.

A. Broad-Based Index

The Commission finds that classifying the Index as broad-based, and, thus, permitting Exchange rules applicable to the trading of broad-based index options to apply to MidCap 400 options is appropriate. Specifically, the Commission believes it is consistent with the Act to designate the Index as broad-based because the MidCap 400 reflects a substantial segment of the U.S. equities market, in general, and mid-level capitalized U.S. securities, in particular. The Index consists of 400 of the most actively traded middle-capitalized securities in the United

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[20] 15 U.S.C. 78f(b)(5) (1988).

States.[21] In addition, as of January 6, 2004, the total capitalization of the Index was approximately $ 962.075 billion. The MidCap 400 also includes stocks of companies from ten market sectors, no one of which dominates the Index.[22] Moreover, the Index represents a broad cross-section of domestic mid-level capitalized stocks, with no single stock comprising more than 1.23% of the Index's total value (as of January 6, 2004). The percentage weighting of the five largest components in the Index also accounts for only 4.66% of the Index's value. Finally, 344 (86%) of the 400 stocks included in the Index, representing 88.1% of the total weight of the Index, are the subject of standardized options trading, and many of the other Index component stocks are eligible for options trading (as of January 6, 2004).

B. Index Design and Structure

The broad diversification, large capitalization, and liquid markets of the Index's component stocks significantly minimizes the potential for manipulation of the Index. First, as discussed above, the Index represents a broad cross-section of domestic mid-level capitalized stocks, with no single industry group or stock dominating the Index. Second, the overwhelming majority of the stocks that comprise the Index are actively traded, with a mean and median average daily trading volume of 437,107 and 724,445 shares, respectively.[23]

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21 Specifically, the mean and median capitalization for the 400 companies, as of January 6, 2004, was $ 2.4 billion and $ 2.1 billion, respectively.

22 Specifically, as of February 26, 2004, the ten market sectors along with their respective weighting in the Index was as follows: (1) energy, 5.5%; (2) materials, 6.3%; (3) industrials, 14.5%; (4) consumer discretionary, 16.3%; (5) consumer staples, 4.5%; (6) health care, 9.5%; (7) financials, 16.5%; (8) information technology, 19%; (9) telecommunications services, 0.8%; and (10) utilities, 7.3%.

23 For the six-month period ending January 2004, 398 of the 400 (99.5%) companies within the Index had an average daily trading volume greater than 30,000 shares per day. Those companies represent 99.25% of the market capitalization of the Index. The average daily trading volume of the 20 most heavily traded companies in the Index, representing 7.51% of the market capitalization of the Index, was 3,784,032 shares per day.

Third, S&P has developed procedures and criteria designed to ensure that the Index maintains its broad representative sample of stocks in the middle-capitalization range of securities.[24] Accordingly, the Commission believes it is unlikely that attempted manipulations of the prices of a small number of issues would affect significantly the Index's value.

C. Surveillance

The Exchange represents that it has an adequate surveillance program in place for the Exchange's other index options (at present, options on the S&P SmallCap 600 Index) and intends to apply those same program procedures to the options on the Index. Additionally, the Exchange is a member of the Intermarket Survelliance Group ("ISG"), which allows for the sharing of surveillance information for potential intermarket trading abuses pursuant to the Intermarket Surveillance Group Agreement (the "Agreement").[25] The members of the ISG include all of the U.S. registered stock and options markets. The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchanges trading the stocks underlying the derivative product is an important measure for 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.

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24 See supra notes 11-14 and accompanying text.

25 ISG was formed on July 14, 1983, among other things, to coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. See Intermarket Surveillance Group Agreement, July 14, 1983. The participation of exchanges within the ISG and their sharing of surveillance information is governed by the Agreement. The most recent amendment to the Agreement, which incorporates the original agreement and all amendments made thereafter, was signed by members January 29, 1990. See Second Amendment to Intermarket Surveillance Group Agreement, January 29, 1990.

D. Market Impact

The Commission believes that the listing and trading of MidCap 400 options, including LEAPS and reduced-value LEAPS, on the Exchange will not adversely impact the underlying securities markets. First, as described above, the Index is broad-based and no one stock or industry group dominates the Index. Second, as noted above, the stocks contained in the Index have large capitalizations and are actively traded. Third, existing ISE stock index options rules and surveillance procedures will apply to MidCap 400 options. Fourth, the Exchange has established position and exercise limits for the MidCap 400 options that will serve to minimize potential manipulation and market impact concerns. Fifth, the risk to investors of contra-party non-performance will be minimized because the Index options and Index LEAPS will be issued and guaranteed by the Options Clearing Corporation just like other standardized options traded in the United States.

Finally, the Commission believes that the ISE's other proposed rule changes to accommodate the trading of S&P MidCap 400 options, such as strike price intervals, are consistent with the Act. Based on representations from the ISE, the Commission also believes that the Exchange will have sufficient capacity to accommodate the anticipated order flow. The Commission also believes the Amex's proposed expiration cycle for the S&P MidCap 400 options is reasonable because it provides investors sufficient flexibility to establish their desired options positions.

V. Conclusion

IS IT THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[26] that the proposed rule change, as amended, (SR-ISE-2004-08) is hereby approved on an accelerated basis.

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

J. Lynn Taylor
Assistant Secretary

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26 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

27 17 CFR 200.30-3(a)(12).