

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51913; File No. SR-ISE-2004-28)

June 23, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Order Approving Proposed Rule Change and Amendments No. 1 and 2 Relating to Trading Options on Full and Reduced Values of the ISE 250 Index, the ISE 100 Index and the ISE 50 Index, Including Long-Term Options

I. Introduction

On September 10, 2004, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposal to trade options on three broad-based indexes, the ISE 250 Index, the ISE 100 Index and the ISE 50 Index. The ISE submitted Amendments No. 1 and No. 2 to the proposal on January 5, 2005,³ and on March 7, 2005, respectively.⁴ The proposed rule change and Amendments No. 1 and No. 2 were published for comment in the Federal Register on April 6, 2005.⁵ The Commission received no comment letters regarding the proposal. This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 set forth a list of the underlying components of the ISE Indexes.

⁴ Amendment No. 2 replaced the original filing in its entirety, proposed a reduced number of contracts for position and exercise limits, addressed one of the events that the Exchange will monitor on an annual basis, and made other technical corrections to the filing.

⁵ See Securities Exchange Act Release No. 51447 (March 30, 2005), 70 FR 17484 ("Notice").

II. Description of the Proposal

The ISE proposes to list and trade cash-settled, European-style, index options on full and reduced values of the ISE 250 Index, the ISE 100 Index and the ISE 50 Index (collectively, the “ISE Indexes”).⁶ Specifically, the Exchange proposes to list options based upon the full value of the ISE Indexes (“Full-size ISE Indexes”) as well as one-tenth of the value of the ISE Indexes (“Mini ISE Indexes”).

A brief description of the proposal appears below; the Notice provides a more detailed description of the proposal.

Index Design and Composition

The ISE Indexes are designed to track the performance of the most highly capitalized publicly traded companies in the United States. Each index is a float-adjusted capitalization-weighted index,⁷ whose components are all headquartered in the United States and listed on either the New York Stock Exchange, Inc. (“NYSE”), the National Association of Securities Dealers, Inc. (“NASD”), Automated Quotation System (“NASDAQ”), or the American Stock Exchange LLC (“Amex”). All companies in the ISE Indexes will either be operating companies or Real Estate Investments Trusts. All other companies, such as Closed-end Funds, Exchange Traded Funds, Holding Companies, Investment Vehicles and Royalty Trusts are not eligible for inclusion.

⁶ A description of each of the ISE Indexes will be available on the Exchange’s publicly available Web site at <http://www.iseoptions.com>.

⁷ The calculation of a float-adjusted, market-weighted index involves taking the summation of the product of the price of each stock in the index and the number of shares available to the public for trading, rather than the total shares outstanding for each issue. In contrast, a price-weighted index involves taking the summation of the prices of the stocks in the index.

Companies are selected for inclusion in the ISE Indexes by the Exchange based on the Exchange's methodology.⁸ Companies may not apply, and may not be nominated, for inclusion. Companies may be added or removed by the Exchange based on the methodology described below. In order for a company to be eligible for inclusion in the ISE Indexes, it must satisfy certain minimum criteria. One of the requirements for inclusion is that a company's ratio of cumulative shares traded to adjusted shares outstanding must be greater than 0.30 over the past 12 months. Another requirement that must be met by each company is the number of shares in its public float must constitute at least 50% of its total number of outstanding shares. To be eligible for inclusion in the ISE 100 Index, companies must meet one additional requirement: options on the component company's stock must be listed on the Exchange.

The ISE indexes are calculated and maintained by Standard & Poor's ("S&P") pursuant to the Exchange's rules-based methodology and instructions.

ISE 250 Index

The ISE 250 Index is designed to track the combined performance of the most highly capitalized stocks in the U.S. equity markets and specifically includes the top 250 stocks as ranked by market capitalization.

Components of the ISE 250 Index are selected using a rules-based methodology that is fully transparent. Its original selection pool includes all common stocks listed on the NYSE, Amex and NASDAQ. The entire index universe is ranked in descending order by unadjusted market capitalization. Companies that do not meet component eligibility requirements are removed. If a component has multiple share classes, the most liquid issue for that company is

⁸ Rules governing component selection of the ISE Indexes will be available on the Exchange's publicly available web site at <http://www.iseoptions.com>.

included. The top 250 companies, ranked by market capitalization, are then selected from the remaining universe.

Each component's eligibility and ranking is reviewed twice annually, in June and December of each calendar year. Any necessary component changes are made after the close on the third Friday of June and December, and become effective at the opening on the next trading day. Changes to the ISE 250 Index will be announced on ISE's publicly available Web site five trading days prior to the effective date.

In addition to the scheduled reviews, the ISE 250 Index is reviewed on an ongoing basis to accommodate extraordinary events and corporate actions, such as delistings, bankruptcies, mergers or acquisitions involving index components.

ISE 100 Index

The ISE 100 Index tracks the 100 most actively traded listed options classes on the Exchange. Components of the ISE 100 Index are selected based on the average daily volume of each options class over a six-month period on the Exchange. Its original selection pool includes all equity options listed on the Exchange, ranked by average daily volume over the previous six month period. Companies that do not meet component eligibility requirements are removed. The top 100 companies, ranked by average daily volume, are then selected, and the index is weighted by float-adjusted market capitalization.

Similar to the ISE 250 Index, each component's eligibility and ranking in the ISE 100 Index is reviewed twice annually, in June and December of each calendar year. Any necessary component changes are made after the close on the third Friday of June and December, and become effective at the opening on the next trading day. Changes to the ISE 100 Index will be announced on ISE's publicly available Web site five trading days prior to the effective date.

In addition to the scheduled reviews, the ISE 100 Index is reviewed on an ongoing basis to accommodate extraordinary events and corporate actions, such as delistings, bankruptcies, mergers or acquisitions involving index components.

ISE 50 Index

The ISE 50 Index is a subset of the ISE 250 Index, such that the components of the ISE 50 Index consist of the top 50 components that make up the ISE 250 Index, as ranked by market capitalization. Thus, the criteria for inclusion into the ISE 50 Index, as well as the maintenance of the Index, are identical to those of the ISE 250 Index.

Index Calculation and Index Maintenance

The base index level of the ISE 250 Index, the ISE 100 Index and the ISE 50 Index, as of December 31, 1998, was 250, 100 and 200, respectively. On January 3, 2005, the index level of the ISE 250 Index, the ISE 100 Index and the ISE 50 Index was 227.48, 86.32, and 156.98, respectively. The Exchange proposes to base trading in options on both Full-size ISE Indexes and on fractions of Full-size ISE Indexes. In particular, the Exchange proposes to list options on Mini ISE Indexes that are based on one-tenth of the value of Full-size ISE Indexes.

The Full-size ISE Indexes' and the Mini ISE Indexes' level shall each be calculated continuously, using the last sale price for each component stock in the ISE Indexes, and shall be disseminated every 15 seconds throughout the trading day.⁹

The settlement values for purposes of settling both Full-size ISE Indexes ("Full-size Settlement Value") and Mini ISE Indexes ("Mini Settlement Value") shall be calculated on the

⁹ The ISE Index levels shall be calculated by S&P, on behalf of the Exchange, and disseminated to the Options Price Reporting Authority ("OPRA") by the Exchange. The Exchange shall also disseminate these values to its members. The ISE Indexes will be published daily on the Exchange's publicly available Web site and through major quotation vendors, such as Reuters.

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 a component security in the ISE Indexes does not trade on Settlement Day, the closing price from the previous trading day will be used to calculate both Full-size Settlement Value and Mini Settlement Value. Accordingly, trading in the ISE Indexes will normally cease on the Thursday preceding an Expiration Saturday. S&P shall calculate, and the Exchange shall disseminate, both Full-size Settlement Value and Mini Settlement Value in the same manner as S&P shall calculate, and the Exchange shall disseminate, both Full-Size ISE Indexes’ and Mini ISE Indexes’ levels.

S&P will monitor and maintain the ISE Indexes pursuant to ISE’s methodology and instructions. S&P is responsible for making all necessary adjustments to the ISE Indexes to reflect component deletions, share changes, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to restructuring, mergers, or spin-offs involving the underlying components. Some corporate actions, such as stock splits and stock dividends, require simple changes to the available shares outstanding and the stock prices of the underlying components. The number of common shares outstanding for each component stock will be reviewed every Friday. Share changes of less than 5% will be updated on a quarterly basis, becoming effective after the close on the third Friday of March, June, September and December of each calendar year. The index divisor is adjusted at that time to compensate for the share changes. Share changes greater than 5% will be adjusted after the close on the Wednesday of the

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, options on the ISE Indexes will expire on the third Saturday of the month.

following week. The index divisor change also becomes effective after the close on that day. Changes will be announced on the Exchange's publicly available Web site prior to the effective date. Unscheduled share changes due to corporate actions may be processed the same day they are announced, depending on the time the details are received by S&P. In such cases, the index divisor changes may become effective that same day and immediately announced on the Exchange's publicly available Web site.

The eligibility of each component of the ISE Indexes will be reviewed in June and December of each calendar year. Components that fail to meet the eligibility requirements are replaced with new component companies. Component changes may also occur between review periods if a specific corporate action makes an existing component ineligible. The Exchange maintains a Component Replacement Pool ("CRP") for the ISE Indexes at all times for contingency purposes. The CRP contains at least ten companies that meet the eligibility requirements for the ISE Indexes, ranked by market capitalization for the ISE 250 Index and the ISE 50 Index, and six-month average trading volume for the ISE 100 Index. Components removed from the ISE Indexes are replaced with those from the CRP. Component changes are made after the close on the third Friday of June and December of each calendar year, and become effective at the opening on the next trading day. All such changes will be announced on the Exchange's publicly available Web site at least five trading days prior to the effective date.

The Exchange represents that the ISE Indexes currently satisfy the maintenance criteria and further states that it will monitor and maintain the ISE Indexes on a quarterly basis, at which point the Exchange will notify the Commission's Division of Market Regulation ("Division"), and will cease trading options on the NYSE Indexes if and when: (i) the number of securities in the ISE Indexes drops by 1/3rd or more; (ii) 10% or more of the weight of the ISE Indexes is

represented by component securities having a market value of less than \$75 million; (iii) less than 80% of the weight of the ISE Indexes is represented by component securities that are eligible for options trading pursuant to ISE Rule 502; (iv) 10% or more of the weight of the ISE Indexes is represented by component securities trading less than 20,000 shares per day; or (v) the largest component security accounts for more than 15% of the weight of the ISE Indexes or the largest five components in the aggregate account for more than 40% of the weight of the ISE Indexes.¹² In the event the Indexes fail at any time to satisfy the maintenance criteria, the ISE will not open for trading any additional series of options on the Indexes unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of options on each respective Index has been approved by the Commission under Section 19(b)(2) of the Exchange Act.¹³

Contract Specifications

The ISE Indexes are each broad-based indexes, as defined in ISE Rule 2001(j).¹⁴ Options on the ISE Indexes are European-style and A.M. 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 the ISE Indexes. Exchange rules that are applicable to the trading of options on broad-based indexes will apply to both Full-size ISE Indexes and Mini ISE Indexes.¹⁵

¹² The timeframe for monitoring the ISE Indexes was changed from an annual to a quarterly basis. Telephone conversation between Samir Patel, Assistant General Counsel, ISE, and Mia Zur, Attorney, Division, Commission (March 22, 2005).

¹³ Telephone conversation between Samir Patel, Assistant General Counsel, ISE, and Mia Zur, Attorney, Division, Commission (March 22, 2005).

¹⁴ ISE Rule 2001(j) defines a "market index" or a "broad-based index" to mean an index designed to be representative of a stock market as a whole or of a range of companies in unrelated industries.

¹⁵ See ISE Rules 2000 through 2012.

Specifically, the trading of Full-size ISE Indexes and Mini ISE Indexes will be subject to, among others, Exchange rules governing margin requirements and trading halt procedures for index options.

For each of the Full-size ISE Indexes, the Exchange proposes to establish aggregate position and exercise limits at 50,000 contracts on the same side of the market, provided no more than 30,000 of such contracts are in the nearest expiration month series. For position and exercise limit purposes, Full-size ISE Indexes contracts shall be aggregated with Mini ISE Indexes contracts, where ten (10) Mini ISE Indexes contracts equal one (1) Full-size ISE Index contract.

The Exchange proposes to set strike price intervals at 2½ points for certain near-the-money series in near-term expiration months when each of the ISE Indexes is at a level below 200, and 5 point strike price intervals for other options series with expirations up to one year, and 10 point strike price intervals for longer-term options. The minimum tick size for series trading below \$3 shall be 0.05, and for series trading at or above \$3 shall be 0.10.

The Exchange proposes to list options on the ISE Indexes in the three consecutive near-term expiration months plus up to three successive expiration months in the March cycle. For example, consecutive expirations of January, February, March, plus June, September, and December expirations would be listed.¹⁶ In addition, longer-term option series (“LEAPS”) having up to thirty-six (36) months to expiration may be traded.¹⁷ The interval between

¹⁶ See ISE Rule 2009(a)(3).

¹⁷ See ISE Rule 2009(b)(1). LEAPS will be available on the Full and Reduced Value ISE Indexes. However, the Exchange is not listing reduced value LEAPS on the Reduced Value ISE Indexes pursuant to ISE Rule 2009(b)(2). Telephone conversation between Samir Patel, Assistant General Counsel, ISE, and Mia Zur, Attorney, Division, Commission (March 11, 2005).

expiration months on the ISE Indexes shall not be less than six months. The trading of any long-term ISE Indexes shall be subject to the same rules that govern the trading of all the Exchange's index options, including sales practice rules, margin requirements, trading rules and position and exercise limits.

Surveillance and Capacity

The ISE represents that it has an adequate surveillance program in place for options traded on the ISE Indexes, and intends to apply those same program procedures that it applies to the Exchange's other index options. 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., the Chicago Board Options Exchange, the Chicago Stock Exchange, Inc., the National Stock Exchange, Inc., the NASD, the NYSE, the Pacific Stock Exchange, Inc. and the Philadelphia Stock Exchange, Inc. 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 represented that it has the system capacity to adequately handle all series that would be permitted to be added by this proposal, including LEAPS on the Full and Reduced Value ISE Indexes. The Exchange provided to the Commission information in a confidential submission that supports its system capacity representations that will result from the introduction of both Full-size ISE Indexes and Mini ISE Indexes.

III. 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.¹⁸ The Commission finds that the trading of options on full and reduced values of the ISE Indexes will permit investors to participate in the price movements of the securities that comprise the Indexes. The Commission also believes that the trading of options on the ISE Indexes will allow investors holding positions in some or all of the securities underlying the Index to hedge the risks associated with their portfolios. Accordingly, the Commission believes that options on the ISE Indexes 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 options on the ISE Indexes will serve to protect investors, promote the public interest, and contribute to the maintenance of fair and orderly markets.¹⁹

¹⁸ 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).

¹⁹ 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 outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the Commission believes that options on the ISE Indexes will provide investors with a hedging and investment vehicle that should reflect the overall movement of a substantial segment of the capital markets.

The trading of options on the ISE Indexes, 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 ISE 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 ISE Indexes as broad-based for purposes of index options trading, and therefore appropriate to permit ISE rules applicable to the trading of broad-based index options to apply to the new ISE Index options. As noted above, the ISE 250 Index is comprised of the top 250 stocks in the U.S. capital markets as ranked by market capitalization; the ISE 100 is comprised of the equity securities underlying the most actively traded listed options classes on the ISE; and the ISE 50 is comprised of a subset of the ISE 250 Index, such that the components of the ISE 50 Index consist of the top 50 components that make up the ISE 250 Index, as ranked by market capitalization.

ISE 250 Index

The Commission believes that the ISE 250 Index is broad-based because it reflects a substantial segment of the U.S. equity markets. First, the Index represents various diverse segments of the U.S. securities markets. Second, the Index, which is designed to track the overall U.S. market, is composed of highly capitalized, actively traded securities. According to the ISE, as of June 11, 2004, 99.2% of the components were options eligible, as measured by weighting, and 97.2% of the components were options eligible, as measured by number. As of June 11, 2004, the total capitalization of all of the components in the Index was \$8.63 trillion, and the mean capitalization of the Index's components was approximately \$34.51 billion. Third,

no single stock or group of stocks dominate the index with the largest Index component accounting for 3.8% of the weight of the Index, and the five highest weighted securities accounting for 15.9% of the weight of the Index, as of June 11, 2004. Based on the above, the Commission believes the ISE 250 Index is appropriately classified as a broad based index under ISE rules.

The Commission also believes that the general broad diversification, capitalizations, liquidity, and relative weighting of the component securities of the ISE 250 Index minimize the potential for manipulation of the Index. First, the Index is comprised of 250 components listed and actively traded on the NYSE, NASDAQ or Amex, and no single security dominates the Index. Second, as of June 11, 2004, the total Index capitalization was approximately \$8.63 trillion, the median and mean capitalizations of the Index's components were approximately \$16.85 billion and \$34.51 billion, respectively, and the capitalizations of the Index's components ranged from a high of approximately \$328.14 billion for the highest-weighted component (which represented 3.8% of the weight of the Index) to a low of approximately \$5.47 billion for the lowest-weighted Index component (which represented 0.1% of the weight of the Index). As of June 11, 2004, the capitalizations of the Index's five most heavily weighted components, which represented 15.9% of the weight of the Index, ranged from approximately \$241 billion to approximately \$328 billion. Third, as of June 11, 2004, mean and median six-month average daily trading volume of the Index's components was 5.292 million shares and 2.81 million shares, respectively, and 100% of the Index's components had six-month average daily trading volume of at least 50,000 shares. Fourth, as of June 11, 2004, components representing 99.2% of the weight of the Index were options eligible. Fifth, the ISE has represented that it will monitor and maintain the Index on a quarterly basis at which point the Exchange will notify the Division,

and will cease trading options on the Index if and when: (i) the number of securities in the Index drops by 1/3rd or more; (ii) 10% or more of the weight of the Index is represented by component securities having a market value of less than \$75 million; (iii) less than 80% of the weight of the Index is represented by component securities that are eligible for options trading pursuant to ISE Rule 502; (iv) 10% or more of the weight of the Index is represented by component securities trading less than 20,000 shares per day; or (v) the largest component security accounts for more than 15% of the weight of the Index or the largest five components in the aggregate account for more than 40% of the weight of the ISE Indexes.²⁰ In the event the Index fails at any time to satisfy the maintenance criteria, the ISE will not open for trading any additional series of options on the Index unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of options on the Index has been approved by the Commission under Section 19(b)(2) of the Exchange Act.²¹

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 options on the ISE 250 Index are designed to minimize the potential for manipulation and other market impact concerns. The position and exercise limits for the options on the ISE 250 Index is comparable to

²⁰ The timeframe for monitoring the ISE Indexes was changed from an annual to a quarterly basis. Telephone conversation between Samir Patel, Assistant General Counsel, ISE, and Mia Zur, Attorney, Division of Market Regulation (“Division”), Commission (March 22, 2005).

²¹ Telephone conversation between Samir Patel, Assistant General Counsel, ISE, and Mia Zur, Attorney, Division, Commission (March 22, 2005).

the position and exercise limits approved for other index options.²²

ISE 100 Index

The Commission believes that the ISE 100 Index is broad-based because it reflects a substantial segment of the U.S. equity markets. First, the Index represents various diverse segments of the U.S. securities markets. Second, the Index, which is designed to track the overall U.S. market, is composed of highly capitalized, actively traded securities. According to the ISE, as of June 11, 2004, 100% of the components were options eligible, as measured by weighting, and 100% of the components were options eligible, as measured by number. Second, as of June 11, 2004, the total capitalization of the Index was approximately \$5.36 trillion. Third, no single stock or group of stocks dominate the index with the largest Index component accounting for 6.1% of the weight of the Index, and the five highest weighted securities accounting for 25.6% of the weight of the Index, as of June 11, 2004. Based on the above, the Commission believes the ISE 100 Index is appropriately classified as a broad based index under ISE rules.

The Commission also believes that the general broad diversification, capitalizations, liquidity, and relative weighting of the component securities of the ISE 100 Index minimize the potential for manipulation of the Index. First, the Index is comprised of 100 components listed and actively traded on the NYSE, NASDAQ or Amex, and no single security dominates the

²² See, e.g., Securities Exchange Act Release Nos. 48884 (December 5, 2003), 68 FR 69753 (December 15, 2003) (File No. SR-Phlx-2003-66) (order approving the listing and trading of Nasdaq 1000 Index options, with position limits of 50,000 contracts on either side of the market and no more than 30,000 contracts in series in the nearest expiration month); 31382 (October 30, 1992), 57 FR 52802 (November 5, 1992) (File No. SR-CBOE-92-02) (approving the listing and trading of options on the Russell 2000 Index, with position limits of 50,000 contracts on either side of the market and no more than 30,000 contracts in series in the nearest expiration month); and 50937 (December 27,

Index. Second, as of June 11, 2004, the total Index capitalization was approximately \$5.36 trillion, the median and mean capitalizations of the Index's components were approximately \$26.09 billion and \$53.65 billion, respectively, and the capitalizations of the Index's components ranged from a high of approximately \$328.14 billion for the highest-weighted component (which represented 6.1% of the weight of the Index) to a low of approximately \$104.44 billion for the lowest-weighted Index component (which represented 0.002% of the weight of the Index). As of June 11, 2004, the capitalizations of the Index's five most heavily weighted components, which represented 25.6% of the weight of the Index, ranged from approximately \$241 billion to approximately \$328 billion. Third, as of June 11, 2004, mean and median six-month average daily trading volume of the Index's components was 11.58 million shares and 6.84 million shares, respectively, and 100% of the Index's components had six-month average daily trading volume of at least 50,000 shares. Fourth, as of June 11, 2004, 100% of the components were options eligible, as measured by weighting, and 100% of the components were options eligible, as measured by number. Fifth, the ISE has represented that it will monitor the Index on a quarterly basis at which point the Exchange will notify the Division, and will cease trading options on the Index if and when: (1) the number of securities in the Index drops by 1/3rd or more; (2) 10% or more of the weight of the Index is represented by component securities having a market value of less than \$75 million; (3) less than 80% of the weight of the Index is represented by component securities that are eligible for options trading pursuant to ISE Rule 502; (4) 10% or more of the weight of the Index is represented by component securities trading less than 20,000 shares per day; or (5) the largest component security accounts for more than

2004), 70 FR 416 (January 4, 2005) (File No. SR-ISE-2004-09) (order approving the listing and trading of options on the S&P 1000 Index).

15% of the weight of the Index or the largest five components in the aggregate account for more than 40% of the weight of the Index.

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 options on the ISE 100 Index are designed to minimize the potential for manipulation and other market impact concerns. The position and exercise limits for the options on the ISE 100 Index is comparable to the position and exercise limits approved for other index options.²³

ISE 50 Index

The Commission believes that the ISE 50 Index is broad-based because it, as a subset of the ISE 250 Index, likewise reflects a substantial segment of the U.S. equity markets. First, the Index represents various diverse segments of the U.S. securities markets. Second, the Index, which is designed to track the overall U.S. market, is composed of highly capitalized, actively traded securities. According to the ISE, as of June 11, 2004, 100% of the components were options eligible, as measured by weighting, and 100% of the components were options eligible, as measured by number. As of June 11, 2004, the total capitalization of the Index was approximately \$5.18 trillion. Third, no single stock or group of stocks dominate the index with the largest Index component accounting for 6.3% of the weight of the Index, and the five highest weighted securities accounting for 26.5% of the weight of the Index, as of June 11, 2004. Based on the above, the Commission believes the ISE 50 Index is appropriately classified as a broad

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See supra note 22.

based index under ISE rules.

The Commission also believes that the general broad diversification, capitalizations, liquidity, and relative weighting of the component securities of the ISE 50 Index minimize the potential for manipulation of the Index. First, the Index is comprised of a subset of the ISE 250 Index, such that the components of the ISE 50 Index consist of the top 50 components that make up the ISE 250 Index, as ranked by market capitalization, and no single security dominates the Index. As noted above, the components are comprised of the 50 most highly capitalized stocks that are actively traded on the NYSE, NASDAQ or Amex. Second, as of June 11, 2004, the total Index capitalization was approximately \$5.18 trillion, the median and mean capitalizations of the Index's components were approximately \$73.7 billion and \$103.5 billion, respectively, and the capitalizations of the Index's components ranged from a high of approximately \$328.14 billion for the highest-weighted component (which represented 6.3% of the weight of the Index) to a low of approximately \$24.86 billion for the lowest-weighted Index component (which represented 0.5% of the weight of the Index). As of June 11, 2004, the capitalizations of the Index's five most heavily weighted components, which represented 26.5% of the weight of the Index, ranged from approximately \$271.9 billion to approximately \$328.14 billion. Third, as of June 11, 2004, mean and median six-month average daily trading volume of the Index's components was 11.63 million shares and 6.64 million shares, respectively, and 100% of the Index's components had six-month average daily trading volume of at least 50,000 shares. Fourth, as of June 11, 2004, 100% of the components were options eligible, as measured by weighting, and 100% of the components were options eligible, as measured by number. Fifth, the ISE has represented that it will monitor the Index on a quarterly basis at which point the Exchange will notify the Division, and will cease trading options on the Index if and when: (1)

the number of securities in the Index drops by 1/3rd or more; (2) 10% or more of the weight of the Index is represented by component securities having a market value of less than \$75 million; (3) less than 80% of the weight of the Index is represented by component securities that are eligible for options trading pursuant to ISE Rule 502; (4) 10% or more of the weight of the Index is represented by component securities trading less than 20,000 shares per day; or (5) the largest component security accounts for more than 15% of the weight of the Index or the largest five components in the aggregate account for more than 40% of the weight of the Index.

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 options on the ISE 50 Index are designed to minimize the potential for manipulation and other market impact concerns. The position and exercise limits for options on the ISE 50 Index is comparable to the position and exercise limits approved for other index options.²⁴

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 options on the ISE Indexes, 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

²⁴ See supra note 22.

engaged in such trading; and (3) special compliance procedures are applicable to options accounts. Accordingly, because options on the ISE Indexes will be subject to the same regulatory regime as the other standardized options traded currently on the ISE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in options on the ISE Indexes.

C. Surveillance

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 product and the 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 ISE and the NYSE, the NASD, and the Amex are members of the ISG and the ISG Agreement will apply to the trading of Index Options.²⁵ In addition, the ISE will apply to the options on the ISE Indexes the same surveillance procedures it uses currently for existing index options trading on the ISE.

D. Market Impact

The Commission believes that the listing and trading of options on the ISE Indexes will

²⁵ 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.

not adversely impact the underlying securities markets.²⁶ First, as described above, the ISE Indexes are highly capitalized and their underlying components are actively traded. Second, the position and exercise limits applicable to the options on the ISE Indexes should serve to minimize potential manipulation and market impact concerns. Third, the risk to investors of contra-party non-performance will be minimized because the options on the ISE Indexes, like other standardized options traded in the U.S., will be issued and guaranteed by the Options Clearing Corporation. Fourth, existing ISE Index options rules and surveillance procedures will apply to the options on the ISE Indexes.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁷ that the proposed rule change (SR-ISE-2004-28), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁸

Margaret H. McFarland
Deputy Secretary

²⁶ As noted above, the ISE represented in a confidential submission to the Commission that it has the necessary systems capacity to support the introduction of options on the ISE Indexes.

²⁷ 15 U.S.C. 78s(b)(2).

²⁸ 17 CFR 200.30-3(a)(12).