For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[19]

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50937; File No. SR–ISE–2004–09]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 and No. 2 by the International Securities Exchange, Inc., Relating to the Listing and Trading of Options on the S&P 1000 Index

December 27, 2004.

I. Introduction

On April 5, 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 list and trade options based on one-tenth and one one-hundredth of the value of the Standard & Poor's 1000 Index (''S&P 1000'' or ''Index''). The ISE submitted Amendment Nos. 1 and No. 2 to the proposal on July 16, 2004,[3] and August 2, 2004,[4] respectively. The proposed rule change and Amendment Nos. 1 and No. 2 were published for comment in the **Federal Register** on November 22, 2004.[5] The Commission received no comment letters regarding this proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposal

The ISE proposes to list and trade the following A.M. cash-settled, European-style options: (1) Reduced Value S&P 1000 Options (''Reduced Value S&P 1000 Options'' or ''Reduced Value Index Options'') based on one-tenth of the value of the Index; (2) Micro S&P 1000 Index Options (''Micro S&P 1000 Options'' or ''Micro Index Options'') based on one-hundredth of the value of the Index; (3) long-term Reduced Value Index Options; and (4) long-term Micro Index Options (the Reduced Value Index Options, Micro Index Options, long-term Reduced Value Index Options, and long-term Micro Index Options may be referred to, collectively, as the ''Index Options'').[6]

A brief description of the proposal appears below, the November Release [7] provides a more detailed description of the proposal.

Index Design and Composition

The Index, which was designed and is maintained by Standard & Poor's (''S&P''), is a market capitalization-weighted index that combines the S&P MidCap 400 Index and the S&P SmallCap 600 Index. The MidCap 400 Index is broad-based index designed to measure the performance of the mid-range sector of the U.S. stock market, and the S&P SmallCap 600 is a broad-based index designed to measure the performance of small capitalization U.S. stocks.[8] Becausee the Index is a combination of the S&P MidCap 400 Index and the S&P SmallCap 600 Index, the S&P 1000 does not have its own criteria for selecting Index components. Instead, the selection criteria for the S&P MidCap 400 Index and the S&P SmallCap 600 Index determine the components of the S&P 1000. The S&P 1000 may not contain any component that is a component of the S&P 500 Index.

S&P chooses the components of the S&P MidCap 400 Index and the S&P SmallCap 600 Index on the basis of market capitalization, liquidity, and industry group representation. As of February 18, 2004, the Index's components were listed on the New York Stock Exchange (''NYSE''), Nasdaq, or the American Stock Exchange (''Amex''), and components representing over 98% of the weight of the Index were options eligible.[9] All of the Index components listed on Nasdaq are designated as national market system securities by the National Association of Securities Dealers. As described more fully below, the Index's components are classified in ten market sectors and no single security dominates the Index.

Transition to Float-Adjusted Capitalization Weighting

The S&P 1000 Index currently is a ''full'' market capitalization-weighted index in which the value of the Index is calculated by multiplying, for each component, the total number of shares outstanding by the price per share, adding these values together, and dividing the result by the Index divisor. On March 1, 2004, S&P announced that it would shift its U.S. indexes, including the S&P 1000 to ''float-adjusted'' market capitalization weighting. As a float-adjusted market capitalization weighted index, the value of the Index will be calculated by multiplying, for each component, the number of shares of the component that are available to investors (rather than all of the component's outstanding shares) by the price per share, adding these values together, and dividing the resuult by the Index divisor. As described more fully on S&P's Internet Web site, S&P's float adjustment will exclude from the share available to investors shares held by other publicly traded companies and strategic partners, government agencies, and control groups.[10]

S&P will implement the transition from full market capitalization weighting to float-adjusted market capitalization weighting over an 18-month period. S&P will calculate provisional indexes alongside of the regular indexes so that passive indexers (institutional investors that model their portfolio construction and weighting according to S&P indexes) can control the timing of adjustments. The ISE will not trade options on any provisional index calculated during the transition period, nor does the ISE expect any securities or futures exchange to trade

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[19] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] *See* letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated July 15, 2004, and accompanying Form 19b–4 (''Amendment No. 1''). Amendment No. 1 replaced the filing in its entirety.

[4] *See* letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division, Commission, dated July 28, 2004 (''Amendment No. 2''). Amendment No. 2 made technical changes clarifying the description of the Index and the calculation of the Index settlement value.

[5] *See* Securities Exchange Act Release No. 50674 (November 16, 2003), 69 FR 67974 (''November Release'').

[6] Under ISE Rule 2009(b)(2), ''Long-Term Index Options Series,'' the ISE may list long-term index options that expire from 12 to 60 months from the date of issuance. The Exchange will not list reduced value long-term index options on either of the Reduced Value S&P 1000 Indexes or the Reduced Value Micro S&P 1000 Indexes pursuant to ISE Rule 2009(B)(2)(i). Telephone conversation between Joseph W. Ferraro III, Associate General Counsel, ISE, and Florence Harmon, Senior Special Counsel, Division, Commission, and A. Michael Pierson, Attorney, Division, Commission, on November 16, 2004 (''November 16 Conversation'').

[7] *See supra* note 5.

[8] *See* Exchange Act Release Nos. 48587 (October 2, 2003), 68 FR 58154 (October 8, 2003) (order approving File No. SR–ISE–2003–18) (approving the listing and trading of options on the S&P SmallCap 600 Index) ''S&P SmallCap 600 Order''); and 49696 (May 13, 2004), 69 FR 28962 (May 19, 2004) (order approving File No. SR–ISE–2004–08) (approving the listing and trading of options on the S&P MidCap 400 Index) (''S&P MidCap 400 Order'').

[9] *See infra* note 26 for a description of the options eligibility standards.

[10] *See http://www.freefloat.standardandpoors.com.*

products based on any provisional index during the transition period.

In March 2005, the official index series for S&P's U.S. indexes will shift to partial float adjustment, using float adjustment factors that represent half of the total adjustment. In September 2005, the shift to float adjustment will be completed, the official indexes will be fully float-adjusted, and the provisional indexes will be discontinued. S&P will review float adjustment factors annually in September.

During the transition period, S&P will adjust the divisor of each affected index to maintain continuity across the adjustments. As a result of the divisor adjustments, the Index value will maintain continuity immediately following the adjustments in March 2005 and September 2005. Accordingly, the value of Index Options will not change as a direct result of the float adjustment.

The ISE will provide a link on its Internet Web site to the S&P web site page where float adjustment information is displayed.

Index Calculation and Index Maintenance

The values of the Reduced Value S&P 1000 Index and the Micro S&P 1000 Index will each be calculated continuously, using the last sale price for each component stock in the Index, and will be disseminated every 15 second throughout the trading day.[11] S&P will calculate the settlement value for purposes of settling Reduced Value S&P 1000 Options (''Reduced Value Settlement Value'') and Micro S&P 1000 Options (''Micro Settlement Value'') on the basis of opening market prices on the business day prior to the expiration date of the options (''Settlement Day''). The Settlement Day is normally the Friday preceding ''Expiration Saturday.'' [12] The Exchange will disseminate both the Reduced Value Settlement Value and the Micro Settlement Value.[13]

S&P will monitor and maintain S&P 1000. Although the Exchange is not involved in the maintenance of the Index, the Exchange represents that it will monitor the Index on a quarterly basis and will notify staff in the Division, through a proposed rule change filed pursuant to Rule 19b–4,[14] if and when: (i) The number of securities in the Index drops by ⅓rd 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, ''Criteria for Underlying Securities;'' (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 50% of the weight of the Index.

The Exchange will notify the Division immediately in the event S&P determines to cease maintaining or calculating the Index or in the event the Index values are no longer widely disseminated every 15 seconds. In the event the Index ceases to be maintained or calculated, or widely disseminated every 15 seconds, the Exchange will not list any additional series for trading and will limit all transactions in Index Options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.[15]

Contract Specifications

The ISE proposes to characterize the Index as a broad-based index as defined in ISE Rule 2001(j).[16] Exchange rules applicable to the trading of options on broad-based indexes, including margin requirements and trading halt procedures, will apply to the trading of Index Options.[17] The Micro S&P 1000 Options will trade independently of and in addition to the Reduced Value S&P 1000 Options, and both products will be subject to the same rules that presently govern the trading of Exchange index options, including, among others, sales practice rules, trading rules, and position and exercise limits.

The ISE proposes to set strike price intervals at 2½ points for certain near-the-money series in near-term expiration months when the Index is below 200, at 5-point intervals for other Index Options series with expirations up to one year, and at 25- to 50-point intervals for longer-term Index Options. For example, if the level of the Reduced Value S&P 1000 is 337.1, the ISE would set strike price intervals at five points for Reduced Value S&P 1000 Options. Because the level of the Micro S&P 1000 would be 33.71, the ISE would set strike price intervals at 2½-points for Micro S&P 1000 Options.

The ISE proposes to list both Reduced Value S&P 1000 Options and Micro S&P 1000 Options 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.[18] In addition, long-term Index Options series having up to 60 months to expiration may be traded.[19] The interval between expiration months for Reduced Value S&P 1000 Index Options or Micro S&P 1000 Index Options will not be less than six months.

The Exchange proposes to establish aggregate position limits for Reduced Value S&P 1000 Options at 50,000 Reduced Value S&P 1000 Options contracts on the same side of the market, provided no more than 30,000 of such Reduced Value S&P 1000 Options contracts are in the nearest expiration month series. The Exchange also proposes to establish aggregate position limits for Micro S&P 1000 Options at 500,000 Micro S&P 1000 Options contracts on the same side of the market, provided that no more than 300,000 of the Micro S&P 1000 Options contracts are in the nearest expiration month series. Reduced Value S&P 1000 Options contracts will be aggregated with the Micro S&P 1000 Options contracts, where 10 Micro S&P 1000 Options contracts equal one Reduced Value S&P 1000 Options contract.[20] Positions in long-term Reduced Value S&P 1000 Options and Micro S&P 1000 Options will be aggregated with positions in Reduced Value S&P 1000 Options and Micro S&P 1000 Options that expire in less than 12 months.[21]

[11] The values of the Reduced Value S&P 1000 and the Micro S&P 1000 will be calculated by S&P and disseminated to Reuters. The Exchange will receive those values from Reuters and disseminate them every 15 seconds between the hours of 9:30 a.m. and 4:15 p.m. to the Options Price Reporting Authority and to its members. The Index is published daily in, among other places, The Wall Street Journal and The New York Times, and is available during trading hours from quotation vendors such as Reuters. Telephone conversation between Joseph W. Ferraro III, Associate General Counsel, ISE, and Florence Harmon, Senior Special Counsel, Division, Commission, on November 9, 2004 (''November 9 Conversation'').

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

[13] *See supra* Amendment No. 2, note 4.

[14] *See supra* November 9 Conversation, note 11.

[15] *Id.*

[16] 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.

[17] *See* ISE Rules 2000 through 2012.

[18] *See* ISE Rule 2009(a)(3).

[19] *See* ISE Rule 2009(b)(1).

[20] The same limits that apply to position limits will apply to exercise limits for these products. *See supra* November 16 Conversation, note 6.

[21] Telephone conversation between Joseph W. Ferraro III, Associate General Counsel, ISE, and Yvonne Fraticelli, Special Counsel, Division, Commission, on December 27, 2004.

Surveillance and Capacity

The ISE represents that it has an adequate surveillance program for index options, and that it intends to apply to Index Options the same program procedures that it applies to the ISE's other index options. In addition, the ISE notes that it is a member of the Intermarket Surveillance Group (''ISG''), which includes all of the registered national securities exchanges and the NASD. The ISE notes that members of the ISG work together to coordinate surveillance and investigative information sharing in the stock and options markets.

In a confidential submission to the Commission, the Exchange provided an analysis supporting its representation that it has the system capacity to adequately handle all options series that could be listed pursuant to this proposal, including long-term Reduced Value Index Options and long-term Micro Index Options.[22]

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.[23] The Commission finds that the trading of Reduced Value S&P 1000 Options, Micro S&P 1000 Options, long-term Reduced Value S&P 1000 Options, and long-term Micro S&P 1000 Options will permit investors to participate in the price movements of the securities that comprise the Index. 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. 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.[24]

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 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 Index as broad-based for purposes of index options trading, and therefore appropriate to permit ISE 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 segment of the U.S. equity market. First, as described more fully above, the Index is comprised of the 400 component stocks of the S&P MidCap 400 Index, which is designed to measure the performance of the mid-range sector of the U.S. stock market, and the 600 component stocks of the S&P SmallCap 600 Index, which is designed to measure the performance of small capitalization U.S. stocks. Both the S&P MidCap 400 Index and the S&P SmallCap 600 Index are broad-based indexes.[25] According to the ISE, as of February 18, 2004, components representing over 98% of the weight of the Index were options eligible.[26] Second, as of March 25, 2004, the Index's components were classified in ten market sectors, which were weighted in the Index as follows: energy (6.37%); materials (4.32%); industrials (13.96%); consumer discretionary (18.52%); consumer staples (4.45%); health care (12.15%); financials (18.15%); information technology (16.06%); telecommunications services (0.51%); and utilities (5.51%). Third, as of February 18, 2004, the total capitalization of the Index was approximately $1.47 trillion, the capitalization of the Index's components ranged from approximately $11.80 billion to approximately $72.11 million, and the mean capitalization of the Index's components was approximately $1.47 billion. As of February 18, 2004, the largest Index component accounted for 0.80% of the weight of the Index, and the five highest weighted securities accounted for 3.14% of the weight of the Index. Fourth, because the Index is a combination of two broad-based indexes, the S&P MidCap 400 Index and the S&P SmallCap 600 Index, and the selection and maintenance criteria for S&P MidCap 400 Index and the S&P SmallCap 600 Index determine the components of the S&P 1000, the selection and maintenance criteria for the S&P MidCap 400 Index and the S&P SmallCap 600 Index should serve to ensure that the Index maintains its broad representative sample of stocks.[27]

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 1000 components listed and traded on the NYSE, Nasdaq, or the Amex, and no single security dominates the Index. Second, as of February 18, 2004, the total Index capitalization was approximately $1.47 trillion, the median and mean capitalizations of the Index's components were approximately $1.02 billion and $1.47 billion, respectively, and the capitalizations of the Index's components ranged from a high of approximately $11.80 billion for the highest-weighted component (which represented .80% of the weight of the Index) to a low approximately $72.11 million for the lowest-weighted Index component (which represented .005% of the weight of the Index). As of February 18, 2004, the capitalizations of the Index's five most heavily weighted components, which represented 3.14% of the weight of the Index, ranged from approximately $11.80 billion to approximately $9.3 billion. Third, as of

[22] The ISE clarified that its capacity analysis included long-term Reduced Value Index Options and long-term Micro Index Options. Telephone conversation between Florence Harmon, Senior Special Counsel, Division, Commission, and Joseph Ferraro III, Associate General Counsel, ISE, on November 6, 2004.

[23] 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).

[24] 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 the Index Options will provide investors with a hedging and investment vehicle that should reflect the overall movement of a substantial segment of the U.S. equity market.

[25] *See supra* S&P SmallCap 600 Order and S&P MidCap 400 Order, note 8.

[26] 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) the issuer must be in compliance with any applicable requirements of the Exchange Act; (4) trading volume must have been at least 2.4 million shares over the preceding 12 months; and (5) the market price per share must meet specified levels. *See, e.g.*, ISE Rule 502.

[27] As noted above, the S&P 1000 Index does not have its own selection criteria. Instead, the selection criteria for the S&P MidCap 400 Index and the S&P SmallCap 600 Index determine the components of the S&P 1000 Index.

February 18, 2004, mean and median six-month average daily trading volume of the Index's components was 466,190 shares and 252,180 shares, respectively, and 93.6% of the Index's components had six-month average daily trading volume of at least 50,000 shares. Fourth, as of February 18, 2004, components representing over 98% of the weight of the Index were options eligible.[28] Fifth, the ISE has represented that it will monitor the Index on a quarterly basis and will notify Division staff, by a rule filing made pursuant to Rule 19b–4,[29] if and when: (1) The number of securities in the Index drops by ⅓rd 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 50% 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 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.[30]

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 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 Index Options.

As described more fully above, S&P plans to modify the weighting methodology for its U.S. indexes, including the S&P 1000, so that by September 2005 the Index will be a float-adjusted market capitalization weighted index. The ISE notes that S&P plans to modify the Index divisor to maintain the continuity of the Index and, for that reason, the value of Index Options will not change as a direct result of the float adjustment. In addition, the ISE represents that it will provide a link on its Internet web site to the S&P Internet web site page displaying float adjustment information. Accordingly, the Commission believes that investors will be able to obtain information regarding the float adjustment and that the transition to float-adjusted market capitalization should not affect the value of Index Options.

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.[31] In addition, the ISE will apply to the Index Options 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 Index Options will not adversely impact the underlying securities markets.[32] First, the Index is broad-based and comprised of 1000 component securities, no one of which dominates the Index. Second, as described above, the Index is highly capitalized and its components are actively traded. Third, the position and exercise limits applicable to the Index Options 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 ISE index options rules and surveillance procedures will apply to the Index Options.

IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[33] that the proposed rule change (SR–ISE–2004–09), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[34]

Margaret H. McFarland,

Deputy Secretary.

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[28] *See supra* note 26 for a description of the ISE's options eligibility standards.

[29] *See supra* November 9 Conversation, note 11.

[30] *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); and 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).

[31] 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.

[32] 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 the Index Options.

[33] 15 U.S.C. 78s(b)(2).

[34] 17 CFR 200.30–3(a)(12).