assumed rate of 35%, the tax benefit to NU is $6.650 million.

Under the proposed changes to the tax allocation agreement, the consolidated tax would generally be allocated among the Applicants in proportion to the separate return tax of each Applicant, provided that the tax apportioned to any subsidiary of NU will not exceed the tax the subsidiary would have paid if the tax had been computed separately for the subsidiary, with NU allocating the benefits of its own losses generally to its subsidiaries. However, NU would retain the benefit attributable to tax losses it incurs in connection with the Acquisition Debt, rather than reallocate the benefit to its subsidiaries, for the tax year beginning January 1, 2004 and ending when the Acquisition Debt has been paid off. In this respect, the proposed tax allocation agreement does not comply with all of the requirements of rule 45(c). The proposed changes would have the effect of assigning the tax benefit associated with the interest expense on the Acquisition Debt to NU, which is the entity legally obligated for its payment.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–6890 Filed 3–26–04; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49447; File No. SR–ISE–2003–36]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1 Thereto by the International Securities Exchange, Inc., Relating to Trading Options on the Morgan Stanley Technology Index

March 18, 2004.

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 December 4, 2003, the International Securities Exchange, Inc. (''ISE'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in items I and II below, which items have been prepared by the Exchange. On February 27, 2004, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule, as amended, from interested persons and is approving the proposed rule change, as amended, on an accelerated basis.

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

[2] 17 CFR 240.19b–4.

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

The ISE is proposing to trade options on the Morgan Stanley Technology Index (''MSH'' or ''Index''), a stock index developed by Morgan Stanley & Co. Incorporated (''Morgan Stanley'') and calculated and maintained by the American Stock Exchange LLC (''Amex''). The Index is comprised of technology sector stocks that currently trade on the New York Stock Exchange, Inc. (''NYSE'') or that are National Market securities traded through the Nasdaq Stock Market, Inc. (''Nasdaq''). The Commission has previously approved the listing of options on the Index,[4] and those options currently are traded on the Amex. In addition, the Exchange proposes to amend the Supplementary Material to ISE Rule 2001 to include the Index and the Reporting Authority in the disclaimer provisions of the rule. The text of the proposed rule change, as amended, is below. Proposed new language is in *italics*; proposed deletions are in [brackets].

* * * * *

Rule 2001. Definitions

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.*

* * * * *

[3] *See* letter from Joseph W. Ferraro, III, Assistant General Counsel, ISE to Nancy Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated February 26, 2004, enclosing Amendment No. 1, which replaces the original filing in its entirety.

[4] *See* Securities Exchange Act Release Nos. 41472 (June 2, 1999), 64 FR 31331 (June 10, 1999) (SR–Amex–99–14) (approving a reduction in the value of the Index); and 36283 (September 26, 1995), 60 FR 51825 (October 3, 1995) (SR–Amex–95–26) (approving the listing of options on the Index on the Amex) (''Amex Approval'').

Rule 2009. Terms of Index Options Contracts

(a) General.

(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.

(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.

(b) Long-Term Index Options Series.

(1) (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*

(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 than $200.00.

* * * * *

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

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

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

1. Purpose

The Exchange proposes to trade standardized options on the Index. The Index is an equal-dollar weighted index developed by Morgan Stanley, representing a portfolio of large, actively traded technology stocks. The Index comprises 35 U.S. public issuers drawn from 11 technology subsectors, including: Computer and Business Services; Data Networking/Internet Infrastructure; Electronics Manufacturing Services; Enterprise Software; Internet & PC Software; Server & Enterprise Hardware; PC Hardware & Data Storage; Semiconductor Capital Equipment; Semiconductors; Technical Software (CAD/CAM, EDA); Telecom Equipment-Wireline/Wireless.[5]

By way of background, MSH is a narrow-based index, the listing of which normally would not require prior Commission approval pursuant to Rule 19b–4 under the Act.[6] However, for the reasons discussed below, the listing of MSH options does not squarely fit within the procedures in place for the accelerated listing of derivative products, thus giving rise to the need for this filing. The Commission amended Rule 19b–4 in 1998 to eliminate the necessity for self-regulatory organizations (''SROs'') to obtain the Commission's permission to list and trade new derivative securities products if the Commission has approved, pursuant to Rule 19b–4(e), an SRO's trading rules, procedures and listing standards for the product class that would include the new derivative securities product and the SRO has a surveillance program for the product class.[7] Subsequent to the adoption of this amendment, the Commission approved trading rules, procedures and listing standards for the trading of narrow-based index options that allow the options exchanges to initiate trading in index options pursuant to Rule 19b–4(e). These trading rules, procedures and listing standards are uniform among the options exchanges and are contained in Chapter 20 of the ISE's rules and, in particular, ISE Rule 2002.

For a derivative product that meets the standards of an exchange's rules, an SRO need only complete Form 19b–4(e) at least five business days after commencement of trading the new product. However, the Commission approved the Amex's trading of options on the MSH in 1995, prior to adoption of the Form 19b–4(e) filing process. The Index meets all of the requirements of ISE Rule 2002(b), except the requirement that an equal dollar-weighted index be rebalanced at least once every calendar quarter. Thus, ISE may not list this product pursuant to Rule 19b–4(e) under the Act.

a. Index Qualification

ISE Rule 2002(b) contains specific qualification requirements for narrow-based index options. Except for the requirement relating to quarterly rebalancing of an equal dollar-weighted index (discussed below), MSH meets all of those requirements, namely: (1) The index is A.M. settled; (2) the index is equal-dollar weighted and has 35 component securities; (3) each of the component securities has a market capitalization of more than $75 million; (4) the trading volume of each component security has been over one million shares for each of the last six months; (5) each of the component securities represents less than 5% of the weight of the index, and the five highest weighted component securities in the aggregate account for less than 19% of the weight of the index; (6) all of the component securities satisfy the requirement of ISE Rule 502 (initial listing standards) applicable to individual underlying securities; (7) all component securities are ''reported securities'' as defined in Rule 11Aa3–1 under the Act;[8] (8) none of the components are non-U.S. securities that are not subject to comprehensive surveillance agreements; (9) the underlying index value is reported at least once every 15 seconds during the time the index options are traded; and (10) the index is calculated by the Amex in consultation with Morgan Stanley, which is a broker-dealer that has a ''Chinese Wall'' around its personnel who have access to information concerning changes in, and adjustments to, the Index.[9]

In addition, Morgan Stanley has included in the Index only those stocks that meet the following standards: (1) A minimum market capitalization of $75 million; (2) average monthly trading volume of at least one million shares during the preceding six months; (3) each component security must be traded on the Amex or the NYSE, or must be a National Market security traded through Nasdaq; and (4) upon annual rebalancing, at least 90% of the Index's numerical value and at least 80% of the total number of component securities must meet the then current criteria for standardized options trading set forth in Amex Rule 915.[10] Also, because the Index is equal-dollar weighted, no component security will represent more than 25% of the weight of the Index, nor will the five highest weighted component securities in the Index, in the aggregate, account for more than 60% of the weight of the Index at each annual rebalancing. Specifically, at each rebalancing, each component security will account for approximately 2.86% of the weight of the Index.[11] As of February 18, 2004, all of the Index

[5] The specific components of the Index are: Xilinx Inc.; Microsoft Corp.; Motorola Inc.; Computer Associates International Inc.; Accenture Ltd.; L.M. Ericsson Telephone Co.; Qualcomm Inc.; Electronic Data Systems Corp.; First Data Corp.; Veritas Software Corp.; Automatic Data Processing Inc.; Nokia Corp.; Juniper Networks Inc.; International Business Machines Corp.; Texas Instruments Inc.; Amazon.Com Inc.; Stmicroelectronics N.V.; Broadcom Corp.; Emc Corp.; Interactivecorp.; Micron Technology Inc.; Flextronics International Ltd.; Ebay Inc.; Yahoo! Inc.; Agilent Technologies Inc.; Intel Corp.; Hewlett-Packard Co.; Cisco Systems Inc.; Electronic Arts Inc.; Oracle Corp.; Intuit Inc.; Peoplesoft Inc.; Applied Materials Inc.; Dell Inc.; and Seagate Technology Inc.

[6] 17 CFR 240.19b–4.

[7] *See* Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998) (File No. S7–13–98) (establishing the expedited listing and trading of certain derivative products pursuant to Rule 19b–4(e) under the Act).

[8] 17 CFR 240.11Aa3–1.

[9] *See* Amex Approval, *supra* note 4.

[10] Amex Rule 915 is substantively identical to ISE Rule 502.

[11] *See* Securities Exchange Act Release No. 35944 (July 7, 1995), 60 FR 36167 (July 13, 1995) (SR–Amex–95–26).

component securities had standardized options trading on them.

As of the close of trading on February 18, 2004, the Index was valued at 508.78. The market capitalizations of the individual stocks in the Index as of the close of trading on February 18, 2004, ranged from a high of $283.0 billion to a low of $8.0 billion, with the mean and median being $50.9 billion and $26.1 billion, respectively. The market capitalization of all the stocks in the Index on that date was approximately $1.8 trillion. The total number of shares outstanding for the stocks in the Index ranged from a high of 10.8 billion shares to a low of 198.5 million shares. In addition, the average daily trading volume of the stocks in the Index, for the six-month period from August 18, 2003, through February 18, 2004, ranged from a high of 64 million shares per day to a low of 1.8 million shares per day, with the mean and median being 13.6 million and 8.6 million shares, respectively. Lastly, as of the close on February 18, 2004, the highest weighted component security represents 4.54% of the Index, and the lowest weighted component security represents 1.79% of the index.

b. Index Calculation

The Index is calculated using an ''equal-dollar weighting'' methodology designed to ensure that each of the component securities is represented in an approximately ''equal'' dollar amount in the Index at each rebalancing. The Exchange believes that this method of calculation is important because even among the largest companies in the technology sector there is great disparity in market value. For example, although the stocks included in the Index represent many of the highly capitalized companies in the technology sector, the five most highly capitalized companies in the Index currently represent approximately 57% of the aggregate market value of the Index. Since the Index is equal dollar weighted, however (as opposed to market capitalization weighted), these five most highly capitalized companies have, on average, approximately the same weighting in the Index as the five least highly capitalized companies in the Index. It has been the Exchange's experience that options on market value or capitalization weighted indexes dominated by relatively few component stocks are less useful to investors because those indexes tend to represent those few companies and not the targeted industry as a whole.[12]

The following is a description of how the equal-dollar weighting calculating method works. As of the market close on December 16, 1994, a portfolio of technology stocks was established representing an investment of $300,000 in the stock (rounded to the nearest whole share) of each of the securities represented in the Index. The value of the Index equals the current market value (*i.e.*, based on U.S. primary market prices) of the sum of the assigned number of shares of each of the stocks in the Index divided by the Index divisor. The Index divisor was initially determined to yield the benchmark value of 200.00 at the close of trading on December 16, 1994. Annually thereafter, following the close of trading on the third Friday of December, the Index is adjusted by changing the number of whole shares of each component stock so that each company is again represented in approximately ''equal'' dollar amounts. If necessary, a divisor adjustment is made at the rebalancing to ensure continuity of the Index's value.[13] The newly adjusted Index becomes the basis for the Index's value on the first trading day following the annual adjustment.

As noted above, the number of shares of each component stock in the Index remains fixed between annual reviews except in the event of certain types of corporate actions, such as the payment of a dividend (other than an ordinary cash dividend), stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or similar event with respect to the component stocks. In a merger or consolidation of an issuer of a component stock, if the stock remains in the Index, the number of shares of that security in the Index may be adjusted, to the nearest whole share, to maintain the component's relative weight in the Index at the level at which it was represented immediately prior to the corporate action. In the event of a stock replacement, the average dollar value of the remaining Index components is calculated and that amount invested in the stock of the new component, rounded to the nearest whole share. In all cases, the divisor is adjusted, if necessary, to ensure continuity in the value of the Index.

The value of the Index is calculated continuously and disseminated every 15 seconds over the Consolidated Tape Association's Network B and to the Options Price Reporting Authority.[14]

c. Maintenance of the Index

The one requirement for listing and trading of options on the Index pursuant to Rule 19b–4(e) under the Act[15] that the MSH does not currently meet is the requirement in ISE Rule 2002(b)(11) that an equal dollar-weighted index be rebalanced at least once every calendar quarter. The Amex calculates the Index, which is rebalanced annually. In its initial approval of the MSH for options trading, the Commission included certain specific requirements related to rebalancing of the Index in addition to the annual rebalancing.

The Index is calculated and maintained by the Amex in consultation with Morgan Stanley who may, from time to time, suggest changes in the technology industry categories represented in the Index or changes in the number of component stocks in an industry category to properly reflect the changing conditions in the technology sector. Specifically, the Amex must maintain the Index so that if at any time between annual rebalancings the top five component securities, by weight, account for more than one-third of the weight of the Index, the Index is rebalanced after the close of the trading on the third Friday (''Expiration Friday'') in the next month in the March cycle. The Amex also reviews the Index component securities on a quarterly basis and replaces component securities that fail to meet the following maintenance criteria: (1) A minimum market capitalization of $75 million; (2) average monthly trading volume in the component security of at least 500,000 shares during the preceding six month period; (3) a share price greater than $5.00 for a majority of the trading days during the preceding three month period; and (4) at least 90% of the component securities, by weight, must satisfy the Amex's options eligibility requirements. In addition, the Amex must seek approval from the Commission pursuant to Section 19(b) of the Act prior to increasing the number of components in the Index to more than 46 or decreasing the number of components to less than 24.[16]

At the beginning of each calendar quarter, Morgan Stanley will provide the Amex with a current list of replacement stocks on which to draw in

[12] *See supra* note 6.

[13] On April 13, 1999, Amex proposed to split the Index to one-third of its then current value by tripling the divisor used in calculating the Index. *See* Securities Exchange Act Release No. 41472 (June 2, 1999), 64 FR 31331 (June 10, 1999). However, the Index was split 2-for-1 on March 20, 2000. *See* the American Stock Exchange—The Morgan Stanley Technology Index Option Specifications on the Amex Web site at *www.amex.com*.

[14] *See supra* note 3.

[15] 17 CFR 240.19b–4(e).

[16] *See* Amex Approval, *supra* note 4, at fn 17.

the event that a component in the Index must be replaced due to merger, takeover, or other similar event. The stocks on the replacement list will be selected and ranked by Morgan Stanley based on a number of criteria, including conformity to Amex Rules 915 and 916, which set forth the criteria for the initial and continued listing of standardized options on equity securities, trading liquidity, market capitalization, ability to borrow shares, and share price. The replacement stocks will be categorized by industry within the technology sector and ranked within their category based on the aforementioned criteria. The replacement stock for a security being removed from the Index will be selected by the Amex from the replacement list based on industry category and liquidity.[17]

In addition, Morgan Stanley will advise Amex regarding the handling of unusual corporate actions which may arise from time to time. Routine corporate actions (*e.g.*, stock splits, routine spinoffs, etc.) which require straightforward index divisor adjustments will be handled by Amex staff without consultation with Morgan Stanley. All stock replacements and unusual divisor adjustments caused by the occurrence of extraordinary events such as dissolution, merger, bankruptcy, non-routine spin-offs, or extraordinary dividends will be made by Amex staff in consultation with Morgan Stanley. All stock replacements and the handling of non-routine corporate actions will be announced at least ten business days in advance of such effective change, whenever practicable. As with all options currently trading on the Exchange, the Exchange will make this information available to the public through the dissemination of an information circular.[18]

The Commission concluded in approving the Amex's trading of options on the MSH that the composition and maintenance criteria for the Index were appropriate to minimize the possibility that the Index could be manipulated, and options on the Index continue to trade on the Amex today under these standards. The Exchange believes that these standards continue to be adequate to protect investors. The Exchange shall notify the Market Regulation Division of the Commission immediately in the event Amex 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.

d. Expiration and Settlement, Position and Exercise Limits; Margin Requirements, and Trading Halts

The product specifications of the options on the Index proposed to be traded on the Exchange will be identical to the product specifications of the options on the Index traded on Amex. Specifically, options on the Index are European-style[19] 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 MSH options. MSH options listed on Amex also trade from 9:30 a.m. to 4:15 p.m., New York time. The options on the Index will expire on the Saturday following the third Friday of the expiration month (''Expiration Friday''). The last trading day in an expiring Index option series will normally be the second to last business day preceding the Saturday following Expiration Friday (normally a Thursday). Trading in expiring Index options will cease at the close of trading on the last trading day.

The Exchange plans to list Index options series with expirations in the three near-term calendar months and in two additional calendar months in the March cycle. 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.

Because the Index is a narrow-based index, position and exercise limits on full-value and reduced-value long-term Index options will be equivalent to the position and exercise limits for narrow-based indexes established pursuant to Exchange rules.[20] For aggregation purposes, ten contracts of a reduced-value index series will be equivalent to one full-value contract.[21] For example, since the position limit for the full-value options on the Index is 31,500 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 315,000 contracts on the same side of the market.

Similarly, the margin requirement for the MSH options will be equivalent to those applied to narrow-based index options.[22] In addition, Exchange rules governing and trading halt procedures that are applicable to the trading of narrow-based index options will apply to options traded on the Index.[23]

The exercise settlement value for expiring Index options is calculated based upon the primary exchange regular way opening sale prices for the component stocks, except in the case of Nasdaq National Market System (''Nasdaq/NMS'') components of the Index. Amex revised the settlement value calculation methodology for Nasdaq/NMS component stocks in the Index.[24] Prior to that revision, the Index's settlement value was determined by using the regular-way opening sale price for each of the Index's component stocks in its primary market on the last trading day prior to expiration. Upon that revision, the Index's settlement value calculation is determined by using the volume weighted average price for each Nasdaq/NMS listed Index component, as calculated during the first five minutes of trading immediately following the first reported trade for such component. If no other trades are executed in a Nasdaq/NMS listed Index component during the five minutes following the first reported trade, Amex will use the price of the first reported trade in

[17] For a more complete discussion of the Replacement list, *see* Amex Approval, *supra* note 4.

[18] *See supra* note 4.

[19] European-style options may only be exercised during a specified time period immediately prior to expiration.

[20] Conversation between Joseph W. Ferraro, III, Assistant General Counsel, ISE, and Tim Fox, Attorney, Division, Commission on March 18, 2004. Pursuant to ISE Rules 2005 and 2007, the position and exercise limits for the MSH options will be 31,500 contracts on the same side of the market.

[21] *See* ISE Rule 2004(c).

[22] The ISE represents that the minimum customer margin for uncovered writers of Index contracts will be 100% of the market value of the option plus 20% 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. *See* email from Joseph Ferraro, Assistant General Counsel, ISE to Tim Fox, Attorney, Commission, dated March 10, 2004.

[23] Trading on the Exchange MSH options will be halted or suspended whenever trading in underlying securities whose weighted value represents more than ten percent of the index value is halted or suspended. *See* ISE Rule 2008(c). Conversation between Joseph Ferraro, Assistant General Counsel, ISE and Tim Fox, Attorney, ISE on March 18, 2004.

[24] *See* Securities Exchange Act Release No. 41775 (August 20, 1999), 64 FR 47206 (August 30, 1999) (SR–Amex–99–28).

calculating the settlement value for the Index.[25]

e. Exchange Rules Applicable to Stock Index Options

Exchange Rules 2000 through 2012 will apply to the trading of option contracts based on the Index. The Commission has approved ISE maintenance standards and trading rules applicable to narrow-based index options pursuant to which options on MSH will be traded. These rules, by virtue of their incorporation of other Exchange rules by reference, cover issues such as surveillance and exercise prices.

The Exchange believes that it has an adequate surveillance program in place for index options and intends to use those same program procedures that it applies to the Exchange's other index options (at present, options on the S&P SmallCap 600 Index). Additionally, the Exchange is a member of the Intermarket Surveillance Group (''ISG'') under the Intermarket Surveillance Group Agreement.[26]

The Exchange notes that the Commission's Order granting approval to Amex to trade options on the Index[27] provides that Morgan Stanley has also adopted special procedures to prevent the potential misuses of material, non-public information by the research, sales and trading divisions of the firm in connection with the maintenance of the Index. As discussed in that Order, the stocks on each Replacement List are not eligible to be added to the Index by Amex for a period of three months after receipt of the Replacement List by Amex. Moreover, the Amex publicly disseminates each Replacement List by issuing information circulars so that investors will know in advance which securities will be considered as replacements for the Index. In addition, Morgan Stanley will have a limited role in the stock replacement selection and substitution process. First, when a stock in the Index no longer meets the published criteria as determined following a quarterly review of the components by the Exchange, the Amex will determine, without consultation with Morgan Stanley, which security from the applicable Replacement List will be selected for addition to the Index. Second, the Amex will also make adjustments as a result of stock splits, spin-offs, and otherwise, without consultation with Morgan Stanley. Finally, even in those situations where the Amex consults with Morgan Stanley, upon the occurrence of certain events, the actual replacement stock will be selected solely by Amex from the 45 stocks on the replacement list.

The Index is a narrow-based index, as defined in Exchange Rule 2001(i). The Exchange proposes to set exercise (strike) prices at $5.00 intervals, bracketing the current value of the Index when the Index is above 200. If the Index is below 200, the interval will be $2.50. Pursuant to ISE Rule 2009(b), strike price interval, bid/ask differential and price continuity rules will not apply to the trading of LEAPS on the Index until their time to expiration is less than twelve months. The strike price interval for the reduced-value Index LEAPS will be no less than $2.50 instead of $5.00. In addition, ISE Rule 2009(b) provides that full-value or reduced-value LEAPS on the Index will be issued at no less than six-month intervals and that new strike prices will either be near or bracketing the current Index value. These strike prices intervals are the same intervals used by Amex.[28]

2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is consistent with section 6(b) of the Act[29] in general, and furthers the objectives of section 6(b)(5),[30] in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change, as amended, will impose any burden on competition.

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

The Exchange did not receive any written comments on 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 proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. SR–ISE–2003–36. The file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to the File No. SR–ISE–2003–36 and should be submitted by April 19, 2004.

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

After careful consideration, 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,[31] and, in particular, with the requirements of Section 6(b) of the Act[32] and the rules and regulations thereunder. The Commission finds that the proposed rule change, as amended,

[25] *Id.*

[26] The ISE is a member of the Intermarket Surveillance Group (''ISG'') under the ISG Agreement, as amended. The members of the ISG include all of the U.S. registered stock and options markets: the Amex, the Boston Stock Exchange (''BSE''), the Chicago Board Options Exchange (''CBOE''), the Chicago Stock Exchange (''CHX''), the National Stock Exchange ''NSX''), National Association of Securities Dealers, Inc. (''NASD''), the NYSE, the Pacific Exchange (''PCX'') and the Philadelphia Stock Exchange (''Phlx''). The ISE 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. *See* Securities Exchange Act Release No. 48587 (October 2, 2003), 68 FR 58514 (October 8, 2003) (SR–ISE–2003–18) (approval of trading options on the S&P Small Cap 600 Index on ISE).

[27] *See* Amex Approval, *supra* note 4.

[28] *See* Amex Web site at *www.amex.com.*

[29] 15 U.S.C. 78f(b).

[30] 15 U.S.C. 78f(b)(5).

[31] In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[32] 15 U.S.C. 78f(b).

is consistent with Section 6(b)(5) of the Act,[33] which requires, among other things, that the rules of the Exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and, in general, protect investors and the public interest. Specifically, the Commission finds that the trading of options on the Index, including full-value and reduced-value Index LEAPS, will serve to promote the public interest and help to remove impediments to a free and open securities market by providing investors with an additional means to hedge exposure to market risk associated with stocks in the various high technology industries.

The trading of options on the Index and on a reduced-value Index, however, raises several issues relating to index design, customer protection, surveillance, and market impact. The Commission believes, for the reasons discussed below, that the ISE adequately has addressed these issues.

A. Index Design and Structure

The Commission believes it is appropriate for the Exchange to designate the Index as a narrow-based index for purposes of index options trading. The Index is comprised of a limited number (35) of stocks intended to track a limited range of the technology sector of the stock market. Accordingly, the Commission believes it is appropriate for the ISE to apply its rules governing narrow-based index options to trading in the Index options. The Commission also believes that the large capitalizations, liquid markets, and relative weightings of the Index's component stocks significantly minimize the potential for manipulation of the Index. First, the stocks that comprise the Index are actively traded, with a mean and median average monthly trading volume for the period between August 18, 2003, and February 18, 2004, of 13.6 million and 8.6 million shares, respectively. Second, the market capitalizations of the stocks in the Index are very large, ranging from a high of $283.0 billion to a low of $8.0 billion as of February 18, 2004, with the mean and median being $50.9 billion and $26.1 billion, respectively. Third, because the index is equal dollar-weighted, no one particular stock or group of stocks dominates the Index. Specifically, as of February 18, 2004, no one stock accounted for more than 4.54% of the Index's total value and the percentage weighting of the five highest weighted stocks in the Index accounted for less than 19% of the Index's value. Fourth, the Index will be maintained so that in addition to the other maintenance criteria discussed above, at each quarterly review and rebalancing (annual or otherwise), at least 90% of the weight of the Index will be composed of securities eligible for standardized options trading. Currently, all of the component stocks in the Index have standardized options trading on them. Fifth, Morgan Stanley and the Amex are required to ensure that each component of the Index is subject to last sale reporting requirements in the U.S. pursuant to Rule 11Aa3–1 under the Act.[34] The Commission believes that this further reduces the potential for manipulation of the value of the Index. Finally, the Commission believes that the existing mechanisms to monitor trading activity in the component stocks of the Index, or options on those stocks, will help deter as well as detect any illegal activity.

In addition, even though the Index is only scheduled to be rebalanced annually, the Commission believes that the Amex and Morgan Stanley have developed several composition and maintenance criteria for the Index that will minimize the possibility that the Index could be manipulated through trading in less actively traded securities or securities with smaller prices or floats. First, if at any time during the year the top five components in the Index, by weight, account for more than one-third of the weight of the Index, the Exchange will rebalance the Index following the close of trading on Expiration Friday in the next month in the March cycle. These rebalancing requirements will serve to ensure that any "overweight" stock[35] will be brought back into line with the other stocks, thus ensuring that less capitalized stocks do not become excessively weighted in the Index. Second, after each quarterly review and each rebalancing (annual or otherwise), at least 90% of the weight of the Index will be comprised of stocks that are eligible for standardized options trading. The Commission believes that this requirement will ensure that the Index will be almost entirely made up of stocks with large public floats that are actively traded, thus reducing the likelihood that the Index could be easily manipulated by abusive trading in the smaller stocks contained in the Index. Third, at each quarterly review of the Index, a component may only remain in the Index if it satisfies the maintenance requirements discussed above.[36] These requirements are similar to the continued listing requirements for options on individual equity securities.[37] Lastly, because the Index is narrow-based, the applicable position and exercise limits[38], margin requirements,[39] and trading halts[40] will further reduce the susceptibility of the Index to manipulation.[41]

The Commission notes that certain concerns are raised when a broker-dealer, such as Morgan Stanley, is involved in the development and maintenance of a stock index that underlies an exchange-traded derivative product. For several reasons, however, the Commission believes that this concern has been adequately addressed with respect to options on the Index. First, the value of the Index is to be calculated and disseminated by the Amex so that unless a party independently calculates the Index value, neither Morgan Stanley nor any other party will be in receipt of the values prior to the public dissemination of the Index value. Second, routine corporate actions (*e.g.*, stock splits, routine spinoffs, etc.) will be handled by the Amex without consultation with Morgan Stanley. Third, although stock replacements and unusual divisor adjustments caused by the occurrence of extraordinary events, such as dissolution, merger, bankruptcy, non-routine spinoffs, or extraordinary dividends, will be made by Amex staff in consultation with Morgan Stanley, Amex alone ultimately will select the actual replacement stock from the Replacement List without Morgan Stanley's assistance. Such replacements will be announced publicly at least 10 business days in advance of the effective change by the Amex through the dissemination of an information circular, whenever practicable. Fourth, each Replacement List submitted to the Amex by Morgan Stanley will be published by the Amex and securities cannot be selected from a Replacement

[33] 15 U.S.C. 78f(b)(5).

[34] 17 CFR 240.11Aa3–1.

[35] A stock would be "overweight" if its weight in the Index were greater than the average weight of all of the stocks in the Index. This would occur, for example, if the price of a component stock significantly increased relative to the other stocks in the Index during a particular quarter and prior to the rebalancing.

[36] *See supra* section II (A)(1)(c).

[37] *See* ISE Rule 2002(b).

[38] *See supra* note 20.

[39] *See supra* note 22.

[40] *See supra* note 23.

[41] The ISE represents that the minimum customer margin for uncovered writers is 100% of the market value of the option plus 20% 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. *See* e-mail from Joseph Ferraro, Assistant General Counsel, ISE to Tim Fox, Attorney, Commission, dated March 10, 2004, *see also* ISE Rule 2005.

List for three months after receipt by the Amex. Fifth, the Commission believes that the procedures Morgan Stanley has established to detect and prevent material non-public information concerning the Index from being improperly used by the person or persons responsible for compiling the Replacement Lists, as well as other persons within Morgan Stanley, as discussed above, adequately serve to minimize the susceptibility to manipulation of the Index, the securities in the Index, and securities added to and deleted from any Replacement List. Finally the ISE's existing surveillance procedures for stock index options will apply to the options on the Index and should provide the ISE with adequate information to detect and deter trading abuses that may occur. In summary, the Commission believes that the procedures outlined above help to ensure that Morgan Stanley will not have any informational advantages concerning modifications to the composition of the Index due to its limited role in consulting with Amex on the maintenance of the Index under certain circumstances.

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 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 and Index LEAPS will be subject to the same regulatory regime as the other index options currently traded on the ISE, the Commission believes that adequate safeguards are in place to ensure the protection of investors in the Index options and full-value or reduced value Index LEAPS. Finally, the Amex has stated that it will distribute information circulars to members following rebalancings and prior to component changes to notify members of changes in the composition of the Index. Additionally, the Amex will publicly disseminate each Replacement List by means of information circulars. The Commission believes this should help to protect investors and avoid investor confusion.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a stock index derivative product and the exchange(s) 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. In this regard, the Amex, NYSE, and the NASD are all members of the ISG, which provides for the exchange of all necessary surveillance information.[42]

D. Market Impact

The Commission believes that the listing and trading of Index options, including full-value and reduced-value Index LEAPS on the ISE will not adversely impact the underlying securities markets. First, as described above, due to the ''equal dollar-weighting'' method, no one stock or group of stocks dominates the Index. Second, because at each quarterly review and each rebalancing of the Index, at least 90% of the weight of the Index must be accounted for by stocks that meet the Amex's options listing standards, the component stocks generally will be actively-traded, highly-capitalized stocks. Third, the currently applicable 31,500 contract position and exercise limits will 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 and Index LEAPS will be issued and guaranteed by the Options Clearing Corporation just like any other standardized option traded in the United States. Lastly, the Commission believes that settling expiring Index options (including full-value and reduced-value Index LEAPS) based on the opening prices of component securities is reasonable and consistent with the Act. As noted in other contexts, valuing options for exercise settlement on expiration based on opening prices rather than closing prices may help reduce adverse effects on markets for stocks underlying options on the Index.

The Commission finds good cause, pursuant to section 19(b)(2) of the Act,[43] for approving the proposed rule change, as amended, prior to the 30th day after the date of publication of the notice of the filing thereof in the **Federal Register**. The Commission previously addressed the issues raised by the trading of the Index on an exchange when the Commission approved this product for trading on the Amex,[44] and accelerated approval of the proposal will allow investors to begin trading the options promptly. Moreover, the index meets all of the requirements of ISE Rule 2002(b) except for quarterly rebalancing, which the Commission has previously determined was appropriate given the specific procedures in place for quarterly review and maintenance of the Index. Accordingly, the Commission finds that there is good cause, consistent with section 6(b)(5) and 19(b)(2) of the Act,[45] to approve the proposed rule change, as amended, on an accelerated basis.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[46] that the proposed rule change (SR–ISE–2003–36), as amended, is hereby approved on an accelerated basis.

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

Jill M. Peterson,

Assistant Secretary.

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[42] *See supra* note 26.

[43] 15 U.S.C. 78s(b)(2).

[44] *See* Amex Approval, *supra* note 4.

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

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

[47] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49451; File No. SR–PCX–2004–08]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Demutualization of the Pacific Exchange, Inc.

March 19, 2004.

Pursuant to Section 19(b)(1) of the Securities Act of 1934 (''Act'')[1] and PCX Rule 19b–4 thereunder,[2] notice is hereby given that on February 10, 2004, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to

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

[2] 17 CFR 240.19b–4.