

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51121; File No. SR-ISE-2005-01)

February 1, 2005

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the International Securities Exchange, Inc. to Trade Options, Including LEAPS, on Full and Reduced Values of the Nasdaq 100 Index

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 4, 2005, 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 January 18, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.³ On January 19, 2005, the Exchange filed Amendment No. 2 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and to approve the proposal, as amended, on an accelerated basis.

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

The ISE is proposing to amend its rules to trade options on the full and reduced values of the Nasdaq 100 Index (“Index”). The Exchange also proposes to list and trade long-term options on full and reduced values of the Index. Options on the Index would be cash-settled and have

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 was a partial amendment that modified the proposed index hedge exemption for options on the Nasdaq 100 Index. A conforming change was proposed to the contract specifications in the filing.

⁴ Amendment No. 2 replaced Amendment No. 1 in its entirety. In Amendment No. 2, the ISE again revised the proposed hedge exemption.

European-style exercise provisions. The text of the proposed rule change is available on the ISE's website (<http://www.iseoptions.com>), at the ISE's principal office, and at the Commission's Public Reference Room.

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 amend its rules to provide for the listing and trading on the Exchange of cash-settled, European-style, index options on the full and reduced values of the Nasdaq 100 Index, a stock index calculated and maintained by The Nasdaq Stock Market, Inc. ("Nasdaq").⁵ Specifically, the Exchange proposes to list options based upon the full value of the Nasdaq 100 Index ("Full-size Nasdaq 100 Index" or "NDX") as well as one-tenth of the value of the Nasdaq 100 Index ("Mini Nasdaq 100 Index" or "MNX").⁶ The Exchange also proposes to

⁵ A description of the Index is available on Nasdaq's website at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm.

⁶ Options on NDX and MNX are currently listed for trading on the Chicago Board Options Exchange ("CBOE"). Options on NDX and MNX listed on the Exchange would be identical to the NDX and MNX options listed on CBOE.

list long-term options based upon the full value of the Nasdaq 100 Index (“NDX LEAPS”) and one-tenth of the value of the Nasdaq 100 Index (“MNX LEAPS”).⁷

Index Design and Composition

The Nasdaq 100 Index, launched in January 1985, represents the largest non-financial domestic and international issues listed on Nasdaq based on market capitalization. The Index reflects companies across major industry groups, including computer hardware and software, telecommunications, retail/wholesale trade, and biotechnology.

The Index is calculated using a modified capitalization-weighted methodology. The value of the Index equals the aggregate value of the Index share weights, also known as the Depository Receipt Multiplier, of each of the component securities multiplied by each security’s respective last sale price on Nasdaq or the Nasdaq Official Closing Price (“NOCP”), divided by Adjusted Base Period Market Value (“ABPMV”), and multiplied by the base value. The ABPMV serves the purpose of scaling such aggregate value (otherwise in the trillions) to a lower order of magnitude which is more desirable for Index reporting purposes. If trading in an Index security is halted while the market is open, the last Nasdaq traded price for that security is used for all index computations until trading resumes. If trading is halted before the market is open, the previous day’s NOCP is used. Additionally, the Index is calculated without regard to any dividends on component securities. The methodology is expected to retain, in general, the economic attributes of capitalization weighting, while providing enhanced diversification. To accomplish this, Nasdaq reviews the composition of the Index on a quarterly basis and adjusts

⁷ Under ISE Rule 2009(b), “Long-Term Index Options Series,” the Exchange may list long-term options that expire from 12 to 60 months from the date of issuance.

the weighting of Index components using a proprietary algorithm, if certain pre-established weight distribution requirements are not met.

Nasdaq has certain eligibility requirements for inclusion in the Index.⁸ For example, to be eligible for inclusion in the Index, a component security must be exclusively listed on the Nasdaq National Market, or dually listed on a national securities exchange prior to January 1, 2004.⁹ Only one class of security per issuer is considered for inclusion in the Index.

Additionally, the issuer of a component security cannot be a financial or investment company and cannot currently be involved in bankruptcy proceedings. Criteria for inclusion also require the average daily trading volume of a component security to be at least 200,000 shares on Nasdaq. If a component security is of a foreign issuer, based on its country of incorporation, it must have listed options or be eligible for listed-options trading. In addition, the issuer of a component security must not have entered into any definitive agreement or other arrangement which would result in the security no longer being eligible for inclusion in the Index within the next six months. An issuer of a component security also must not have annual financial statements with an audit opinion where the auditor or the issuer has indicated that the audit opinion cannot be currently relied upon.

As of September 21, 2004, the following were characteristics of the Index:

- the total capitalization of all components of the Index was \$1.693 trillion;

⁸ The initial eligibility criteria and continued eligibility criteria are available on Nasdaq's website at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm.

⁹ In the case of spin-offs, the operating history of the spin-off would be considered. Additionally, if a component security would otherwise qualify to be in the top 25% of securities included in the Index by market capitalization for the six prior consecutive months, it would be eligible if it had been listed for one year.

- regarding component capitalization, (a) the highest capitalization of a component was \$296.39 billion (Microsoft Corp.), (b) the lowest capitalization of a component was \$1.48 billion (First Health Group Corp.), (c) the mean capitalization of the components was \$16.93 billion, and (d) the median capitalization of the components was \$6.34 billion;
- regarding component price per share, (a) the highest price per share of a component was \$90.65 (eBay, Inc.), (b) the lowest price per share of a component was \$2.68 (Level 3 Communications, Inc.), (c) the mean price per share of the components was \$35.00, and (d) the median price per share of the components was \$29.95;
- regarding component weightings, (a) the highest weighting of a component was 8.73% (Microsoft Corp.), (b) the lowest weighting of a component was 0.10% (Compuware Corp.), (c) the mean weighting of the components was 1.00%, (d) the median weighting of the components was 0.52%, and (e) the total weighting of the top five highest weighted components was 27.30% (Microsoft Corp., Qualcomm, Inc., Cisco Systems, Inc., Intel Corp., and eBay, Inc.);
- regarding component available shares, (a) the most available shares of a component was 10.86 billion shares (Microsoft Corp.), (b) the least available shares of a component was 43.74 million shares (Henry Schein, Inc.), (c) the mean available shares of the components was 675.31 million shares, and (d) the median available shares of the components was 250.05 million shares;

- regarding the six-month average daily volumes of the components, (a) the highest six-month average daily volume of a component was 64.62 million shares (Microsoft Corp.), (b) the lowest six-month average daily volume of a component was 348,583 shares (Ryanair Holdings PLC), (c) the mean six-month average daily volume of the components was 7.14 million shares, (d) the median six-month average daily volume of the components was 3.05 million shares, (e) the average of six-month average daily volumes of the five most heavily traded components was 260.46 million shares (Microsoft Corp., Intel Corp., Cisco Systems, Inc., Oracle Corp., and Sun Microsystems, Inc.), and (f) 100% of the components had a six-month average daily volume of at least 50,000; and
- regarding option eligibility, (a) 99.3% of the components were options eligible, as measured by weighting, and (b) 96.0% of the components were options eligible, as measured by number.

Index Calculation and Index Maintenance

In recent years, the value of the Full-size Nasdaq 100 Index has increased significantly, such that the value of the Index stood at 804.64, as of October 7, 2002. As a result, the premium for the Full-size Nasdaq 100 Index options also has increased. The Exchange believes that this has caused Full-size Nasdaq 100 Index options to trade at a level that may be uncomfortably high for retail investors. The Exchange believes that listing options on reduced values would attract a greater source of customer business than if the options were based only on the full value of the Index. The Exchange further believes that listing options on reduced values would provide an opportunity for investors to hedge, or speculate on, the market risk associated with the stocks

comprising the Index. Additionally, by reducing the values of the Index, investors would be able to use this trading vehicle while extending a smaller outlay of capital. The Exchange believes that this should attract additional investors and, in turn, create a more active and liquid trading environment.¹⁰

The Full-size Nasdaq 100 Index and the Mini Nasdaq 100 Index levels are calculated continuously, using the last sale price for each component stock in the Index, and are disseminated every 15 seconds throughout the trading day.¹¹ The Full-size Nasdaq-100 Index level equals the current market value of component stocks multiplied by 125 and then divided by the stocks' market value of the adjusted base period. The adjusted base period market value is determined by multiplying the current market value after adjustments times the previous base period market value and then dividing that result by the current market value before adjustments. To calculate the value of the Mini Nasdaq 100 Index, the full value of the Index is divided by ten. To maintain continuity for the Index's value, the divisor is adjusted periodically to reflect events such as changes in the number of common shares outstanding for component stocks, company additions or deletions, corporate restructurings, or other capitalization changes.

The settlement values for purposes of settling both Full-size Nasdaq 100 Index (“Full-size Settlement Value”) and Mini Nasdaq 100 Index (“Mini Settlement Value”) are calculated

¹⁰ The Exchange believes that options trading on MNX have generated considerable interest from investors, as measured by its robust trading volume on CBOE.

¹¹ Full-size Nasdaq 100 Index and Mini Nasdaq 100 Index levels are disseminated through the Nasdaq Index Dissemination Services (“NIDS”) during normal Nasdaq trading hours (9:30 a.m. to 4:00 p.m. ET). The Index is calculated using Nasdaq prices (not consolidated) during the day and the NOCP for the close. The closing value of the Index may change until 5:15 p.m. ET due to corrections to the NOCP of the component securities. In addition, the Index is published daily on Nasdaq’s website and through major quotation vendors such as Reuters and Thomson’s ILX.

based on a volume-weighted average of prices reported in the first five minutes of trading for each of the component securities on the last business day before the expiration date (“Settlement Day”).¹² The Settlement Day is normally the Friday preceding “Expiration Saturday.”¹³ If a component security in the Index does not trade on Settlement Day, the closing price from the previous trading day would be used to calculate both the Full-size Settlement Value and Mini Settlement Value.¹⁴ Accordingly, trading in options on the Index will normally cease on the Thursday preceding an Expiration Saturday.

Nasdaq monitors and maintains the Index. Nasdaq is responsible for making all necessary adjustments to the Index to reflect component deletions; share changes; stock splits; stock dividends; stock price adjustments due to restructuring, mergers, or spin-offs involving the underlying components; and other corporate actions. 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 component securities are evaluated on an annual basis, except under extraordinary circumstances which may result in an interim evaluation, as follows: securities listed on Nasdaq that meet its eligibility criteria are ranked by market value using closing prices as of the end of October and publicly available total shares outstanding as of the end of November. Eligible component securities which are already in the Index and ranked in the top 100 (based on market value) are retained in the Index. Component securities that are ranked from 101 to 150 are also

¹² The aggregate exercise value of the option contract is calculated by multiplying the Index value by the Index multiplier, which is 100.

¹³ For any given expiration month, options on the Nasdaq 100 Index will expire on the third Saturday of the month.

¹⁴ Full-size Settlement Values and Mini Settlement Values are disseminated by CBOE.

retained provided that each such component security was ranked in the top 100 during the previous ranking review. Components that do not meet these criteria are replaced. The replacement securities chosen are those Index-eligible securities that have the largest market capitalization and are not currently in the Index.

The list of annual additions and deletions to the Index is publicly announced in early December. Changes to the Index are made effective after the close of trading on the third Friday in December. If at any time during the year a component security no longer trades on Nasdaq, or is otherwise determined by Nasdaq to become ineligible for inclusion in the Index, that component security would be replaced with the largest market capitalization component not currently in the Index that met the eligibility criteria described earlier.

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 file a proposed rule change with the Commission pursuant to Rule 19b-4 if: (i) the number of securities in the Index drops by one-third 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 25% 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 further notify the Commission's Division of Market Regulation if Nasdaq determines to cease maintaining and calculating the Index, or if the Index values are not

disseminated every 15 seconds by a widely available source. The ISE has represented that, if the Index ceases to be maintained or calculated, or if the Index values are not disseminated every 15 seconds by a widely available source, it would not list any additional series for trading and would limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

Contract Specifications

The contract specifications for options on the Index are set forth as an Exhibit to the proposed rule change. The proposed contract specifications are identical to the contract specifications of NDX and MNX options that are currently listed on CBOE. The Index is a broad-based index, as defined in Exchange Rule 2001(j). Options on the Nasdaq 100 Index 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. ET), as set forth in ISE Rule 2008(a), would apply to options on the Nasdaq 100 Index. Exchange rules that are applicable to the trading of options on broad-based indexes would apply to both NDX and MNX.¹⁵ Specifically, the trading of NDX and MNX options would be subject to, among others, Exchange rules governing margin requirements and trading halt procedures for index options.

For NDX, the Exchange proposes to establish aggregate position limits at 75,000 contracts on the same side of the market. The Full-size Nasdaq Index contracts would be aggregated with Mini Nasdaq 100 Index contracts, where ten Mini Nasdaq 100 Index contracts equal one Full-size Nasdaq 100 Index contract.¹⁶ The Exchange also is proposing to amend its

¹⁵ See Exchange Rules 2000 through 2012.

¹⁶ The position limits proposed by the Exchange for Nasdaq 100 Index options are identical to those established by CBOE.

Rule 2006(a)(5) to conform it to CBOE Rule 24.4(e) with regard to hedge exemptions for options on NDX and MNX. Specifically, the Exchange seeks to add a table in its Rule 2006(a)(5), similar to the one provided by CBOE Rule 24.4(e), that enumerates the hedge exemption available for NDX and MNX and other broad-based indexes. A hedge exemption of 150,000 contracts and 1,500,000 contracts is available for NDX and MNX, respectively. The Exchange plans to retain its standard limit of 75,000 contracts for other broad-based indexes.¹⁷

The Exchange proposes to apply broad-based index margin requirements for the purchase and sale of options on the Index. Accordingly, purchases of put or call options with nine months or less until expiration must be paid for in full. Writers of uncovered put or call options would be required to deposit or maintain 100% of the option proceeds, plus 15% of the aggregate contract value (current index level x \$100), less any out-of-the-money amount, subject to a minimum of the option proceeds plus 10% of the aggregate contract value for call options and a minimum of the option proceeds plus 10% of the aggregate exercise price amount for put options.

The Exchange proposes to set strike price intervals at least 2 ½ points for certain near-the-money series in near-term expiration months when the Full-size Nasdaq 100 Index or Mini Nasdaq 100 Index is at a level below 200, and 5 point strike price intervals for other options series with expirations up to one year, and at least 10 point strike price intervals for longer-term options. The minimum tick size for series trading below \$3 is \$0.05, and for series trading at or above \$3 is \$0.10. Based on the current index levels, the Exchange plans to set strike price intervals of 5 points and 2 ½ points for NDX and MNX, respectively.

¹⁷ See Amendment No. 2. The same limits that apply to position limits would apply to exercise limits for these products.

The Exchange proposes to list options on both the Full-size Nasdaq 100 Index and the Mini Nasdaq 100 Index 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, longer-term option series having up to 60 months to expiration may be traded.¹⁹ The trading of any long-term Nasdaq 100 Index options would be subject to the same rules that govern the trading of all the Exchange's index options, including sales practice rules, margin requirements, and trading rules.

Surveillance and Capacity

The Exchange represents that it has an adequate surveillance program in place for options traded on the Index 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 American Stock Exchange, the Boston Stock Exchange, CBOE, the Chicago Stock Exchange, the National Stock Exchange, NASD, the New York Stock Exchange, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. 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.

¹⁸ See ISE Rule 2009(a)(3).

¹⁹ NDX LEAPS and MNX LEAPS are listed pursuant to ISE Rule 2009(b)(1) rather than Rule 2009(b)(2).

The Exchange represents that it has the necessary systems capacity to support new options series that would result from the introduction of NDX, MNX, NDX LEAPS, and MNX LEAPS. The Exchange has provided the Commission with system capacity information to support its system capacity representations.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6 of the Act²⁰ in general, and with Section 6(b)(5) in particular,²¹ in that it will permit the trading of options on the Full-size Nasdaq 100 Index and Mini Nasdaq 100 Index pursuant to rules designed to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade.

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

The Exchange does not believe that the proposed rule change would impose any inappropriate burden on competition.

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

The Exchange has not solicited comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Solicitation of Comments

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

²⁰ 15 U.S.C. 78f.

²¹ 15 U.S.C. 78f(b)(5).

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-ISE-2005-01 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-ISE-2005-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of this filing also will be available for inspection and copying at the principal office of the ISE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions

should refer to File Number SR-ISE-2005-01 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

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.²² In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,²³ which requires that the rules of an exchange be 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 a national market system, and in general to protect investors and the public interest. The Commission notes that it previously approved the listing and trading of options on the Nasdaq 100 Index on another exchange.²⁴ The Commission presently is not aware of any regulatory issue that should cause it to revisit that earlier finding or preclude the trading of such options on the ISE.

In approving this proposal, the Commission has specifically relied on the following representations made by the Exchange:

1. The Exchange will notify the Commission's Division of Market Regulation immediately if Nasdaq determines to cease maintaining and calculating the Nasdaq 100 Index, or if the Nasdaq 100 Index values are not disseminated every

²² In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²³ 15 U.S.C. 78f(b)(5).

²⁴ See Securities Exchange Act Release No. 33428 (January 5, 1994), 59 FR 1576 (January 11, 1994).

15 seconds by a widely available source. If the Index ceases to be maintained or calculated, or if the Index values are not disseminated every 15 seconds by a widely available source, the Exchange will not list any additional series for trading and limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

2. The Exchange has an adequate surveillance program in place for options traded on the Nasdaq 100 Index.
3. The additional quote and message traffic that will be generated by listing and trading NDX, MNX, NDX LEAPS, and MNX LEAPS will not exceed the Exchange's current message capacity allocated by the Independent System Capacity Advisor.

The Commission further notes that in approving this proposal, it relied on the Exchange's discussion of how Nasdaq currently calculates the Index. If the manner in which Nasdaq calculates the Index were to change substantially, this approval order might no longer be effective.

In addition, the Commission believes that the position limits for these new options, and the hedge exemption from such position limits, are reasonable and consistent with the Act. The Commission previously has found identical provisions for NDX and MNX options to be consistent with the Act.²⁵

²⁵ See Securities Exchange Act Release No. 44156 (April 6, 2001), 66 FR 19261 (April 13, 2001) (SR-CBOE-00-14) (order approving a proposed rule change by CBOE to increase position and exercise limits for Nasdaq 100 Index options, expand the Index hedge exemption, and eliminate the near-term position limit restriction).

The Commission finds good cause for approving this proposal before the thirtieth day after the publication of notice thereof in the Federal Register. Because options on the Nasdaq 100 Index already trade on another exchange, accelerating approval of the ISE's proposal should benefit investors by creating, without undue delay, additional competition in the market for these options.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁶ that the proposed rule change, as amended (SR-ISE-2005-01), is hereby approved.

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

Margaret H. McFarland
Deputy Secretary

²⁶ 15 U.S.C. 78s(b)(2).

²⁷ 17 CFR 200.30-3(a)(12).