

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50501; File No. SR-NASD-2004-138)

October 7, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Listing and Trading of Performance Leveraged Upside Securities Based on the Value of the Dow Jones Euro Stoxx 50 Index

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 14, 2004, the National Association of Securities Dealers, Inc. (“NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I and II below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposal on an accelerated basis.

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

Nasdaq proposes to list and trade Performance Leveraged Upside Securities<sup>SM</sup> Based (“PLUS”) on the Value of the Dow Jones Euro Stoxx 50 Index (“Notes”) issued by Morgan Stanley (“Morgan Stanley”).

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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

In its filing with the Commission, Nasdaq 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. Nasdaq 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

Nasdaq proposes to list and trade PLUS, the return on which is based upon the Dow Jones Euro Stoxx 50 Index ("Index").

Under NASD Rule 4420(f), Nasdaq may approve for listing and trading innovative securities that cannot be readily categorized under traditional listing guidelines.<sup>3</sup> Nasdaq proposes to list and trade notes based on the Index under NASD Rule 4420(f).

The Notes, which will be registered under Section 12 of the Act, will initially be subject to Nasdaq's listing criteria for other securities under NASD Rule 4420(f). Specifically, under NASD Rule 4420(f)(1):

- (A) The issuer shall have assets in excess of \$100 million and stockholders' equity of at least \$10 million.<sup>4</sup> In the case of an issuer which is unable to satisfy the income criteria set forth in Rule 4420(a)(1), Nasdaq generally will require the

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<sup>3</sup> See Securities Exchange Act Release No. 34-32988 (September 29, 1993), 58 FR 52124 (October 6, 1993).

<sup>4</sup> Morgan Stanley satisfies this listing criterion.

issuer to have the following: (i) assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (ii) assets in excess of \$100 million and stockholders' equity of at least \$20 million;

- (B) There must be a minimum of 400 holders of the security; provided, however, that if the instrument is traded in \$1,000 denominations, there must be a minimum of 100 holders;
- (C) For equity securities designated pursuant to this paragraph, there must be a minimum public distribution of 1,000,000 trading units; and
- (D) The aggregate market value/principal amount of the security will be at least \$4 million.

In addition, Morgan Stanley satisfies the listed marketplace requirement set forth in NASD Rule 4420(f)(2).<sup>5</sup> Lastly, pursuant to NASD Rule 4420(f)(3), prior to the commencement of trading of the Notes, Nasdaq will distribute a circular to members providing guidance regarding compliance responsibilities and requirements, including suitability recommendations, and highlighting the special risks and characteristics of the Notes.<sup>6</sup> In particular, Nasdaq will advise members recommending a transaction in the Notes to: (1) determine that such transaction is suitable for the customer; and (2) have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, such transaction.

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<sup>5</sup> NASD Rule 4420(f)(2) requires issuers of securities designated pursuant to this paragraph to be listed on The Nasdaq National Market or the New York Stock Exchange, Inc. ("NYSE") or be an affiliate of a company listed on The Nasdaq National Market or the NYSE; provided, however, that the provisions of NASD Rule 4450 will be applied to sovereign issuers of "other" securities on a case-by-case basis.

<sup>6</sup> See NASD Rule 2310 and IM 2310-2, discussed below.

The Notes will be subject to Nasdaq's continued listing criterion for other securities pursuant to NASD Rule 4450(c). Under this criterion, the aggregate market value or principal amount of publicly-held units must be at least \$1 million. The Notes also must have at least two registered and active market makers as required by NASD Rule 4310(c)(1). Nasdaq will also consider prohibiting the continued listing of the Notes if Morgan Stanley is not able to meet its obligations on the Notes.

The Notes are medium-term, senior non-convertible debt securities that will be issued by Morgan Stanley. The original public offering price of the Notes will be \$10 per PLUS. Unlike, ordinary debt securities, the Notes will not pay interest and do not guarantee any rate of return of principal at maturity. The Notes also are not subject to redemption by Morgan Stanley or at the option of any beneficial owner before maturity.<sup>7</sup>

At maturity, if the value of the Index has increased, a beneficial owner will be entitled to receive a payment on the Notes based on 300% the amount of that percentage increase, subject to a maximum total payment at maturity that is expected to be between \$15.85 and \$16.30 per Note (the "Maximum Payment at Maturity").<sup>8</sup> Thus, the Notes provide investors the opportunity to obtain leveraged upside returns based on the Index subject to a cap that is expected to represent an appreciation of 58.5% to 63% over the original issue price of the Notes. Unlike ordinary debt securities, the Notes do not guarantee any return of principal at maturity. Therefore, if the value of the Index has declined from the time of pricing to the time of maturity, a beneficial owner will receive less, and possibly significantly less, than the original issue price of \$10 per PLUS.

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<sup>7</sup> The actual maturity date is September 30, 2009.

<sup>8</sup> The actual Maximum Payment at Maturity will be determined at the time of pricing of the Notes.

Any payment that a beneficial owner will be entitled to receive at maturity depends entirely on: (a) the relation of the value of the Index generally on second trading day prior to the date when the Notes are due (the “Final Index Value”); and (b) the value of the Index on the day they are priced for initial sale to the public (the “Initial Index Value”). If the Final Index Value is greater than the Initial Index Value, the payment at maturity per PLUS will equal the lesser of: (a) \$10 plus the Leveraged Upside Payment<sup>9</sup> and (b) the Maximum Payment at Maturity. If the Final Index Value is less than or equal to the Initial Index Value, the payment at maturity per PLUS will equal \$10 times the Index Performance Factor.<sup>10</sup>

The Notes are cash-settled in U.S. dollars and do not give the holder any right to receive a portfolio security, dividend payments or any other ownership right or interest in the portfolio or index of securities comprising the Index. The Commission has previously approved the listing of options on, and other securities the performance of which have been linked to or based on, the Index.<sup>11</sup>

The Index was created and is published by STOXX Limited (“STOXX”), a joint venture founded by SWX-Swiss Exchange, Deutsche Boerse AG, and Dow Jones & Company.<sup>12</sup> The

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<sup>9</sup> The Leveraged Upside Payment is the product of (i) \$10 and (ii) 300% and (iii) the Index Percent Increase (a fraction, the numerator of which is the Final Index Value minus the Initial Index Value and the denominator of which is the Initial Index Value).

<sup>10</sup> The Index Performance Factor is a fraction, the numerator of which is the Final Index Value and the denominator of which is the Initial Index Value.

<sup>11</sup> See Securities Exchange Act Release Nos. 49715 (May 17, 2004), 69 FR 29597 (May 24, 2004) (approving listing and trading of 97% Protected Notes Linked to the Performance of the Global Equity Basket, which included the Index); 46021 (June 3, 2002), 67 FR 39753 (June 10, 2002) (approving listing and trading of notes based on the Dow Jones EURO STOXX 50 Return Index, which is based on the Index); and 40303 (August 4, 1998), 63 FR 42892 (August 11, 1998) (approving listing and trading of BRoad InDex Guarded Equity-linked Securities linked to the value of the Index).

<sup>12</sup> STOXX has an advisory committee composed, in part, of securities firms. STOXX states that while its advisory committee generally advises the STOXX Supervisory Board on

companies that are included in the Index are selected by STOXX and are representative of a broad market and a wide array of European industries. The Index is composed of 50 components stocks of the large-cap markets of the European and Eurozone regions.<sup>13</sup> The component stocks have a high degree of liquidity and represent the largest companies across all market sectors defined by the Dow Jones Global Classification Standard.” Publication of the Index began on February 26, 1998, based on an initial value of the Index of 1,000 at December 31, 1991. The Index is currently calculated by (i) multiplying the per share price of each underlying security by the number of free-float adjusted outstanding shares (and, if the stock is not quoted in euros, then multiplied by the country currency and an exchange factor which reflects the exchange rate between the country currency and the euro); (ii) calculating the sum of all these products (the “Index Aggregate Market Capitalization”); and (iii) dividing the Index Aggregate Market Capitalization by a divisor which represents the Index Aggregate Market Capitalization on the base date of the Index and which can be adjusted to allow changes in the issued share capital of individual underlying securities, including the deletion and addition of stocks, the substitution of stocks, stock dividends and stock splits, to be made without distorting the Index.

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the composition, accuracy, transparency and methodology of the indexes in line with the current Dow Jones STOXX Index Guide, the Supervisory Board makes all decisions on the composition and accuracy of the Index and all changes to the Index methodology. STOXX advises that STOXX has implemented and maintains procedures designed to prevent the use and dissemination of material, non-public information relating to the Dow Jones Euro STOXX 50 Index. Telephone conversation between Alex Kogan, Associate General Counsel, Amex, to Florence Harmon, Senior Special Counsel, Division of Market Regulation (“Division”), Commission, dated October 6, 2004.

<sup>13</sup> Telephone conversation between Alex Kogan, Associate General Counsel, Amex, to Florence Harmon, Senior Special Counsel, Division, Commission, dated October 5, 2004.

The value of the Index is updated by STOXX every 15 seconds when European markets are open. The 15-second value of the Index, the list of the Index components and the current divisor can also be found can be accessed from <http://www.stoxx.com>. Real-time dissemination of the Index, adjusted for fluctuations in foreign currency trading prices after European markets close, is available through vendors such as Bloomberg. In the event, SWX-Swiss Exchange, Deutsche Boerse AG and Dow Jones & Company cease to maintain and disseminate the Index, Nasdaq will contact the Commission staff to consider prohibiting the continued trading of the Notes.<sup>14</sup>

As of August 30, 2004, the highest-weighted stock in the Index had the weight of approximately 7.5%; all other components had lower weights. The top five stocks in the Index had the cumulative weight of approximately 25.1%. The following stock markets are (as of August 30, 2004) the primary listing markets for the Index components: Deutsche Boerse (23.5% of the Index weight), Euronext Amsterdam (18.8%),<sup>15</sup> Borsa Italiana (11.1%), Euronext Paris (30.2%), the Spanish Stock Market (12.9%) and HEX Helsinki (3.5%). A number of the Index components are traded on more than one major European market. In addition, 31 of the 50 Index issuers currently have sponsored ADRs listed on the NYSE, and 9 have non-sponsored ADRs trading in the United States.

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<sup>14</sup> Telephone conference between Alex Kogan, Associate General Counsel, Nasdaq, and Florence Harmon, Senior Special Counsel, Division, dated October 4, 2004.

<sup>15</sup> One of the component stocks with a primary listing in Amsterdam maintains a second “primary listing” on Euronext Brussels. This component comprises approximately 1.6% of the total Index weight.

As of August 30, 2004, the average daily trading volume for a single Index component was approximately 9.63 million shares.<sup>16</sup> As of the same date, the market capitalization of the components ranged from approximately 105 billion euros to approximately 8 billion euros. These figures corresponded approximately to 126.8 billion U.S. dollars and 9.6 billion U.S. dollars.

The composition of the Index is reviewed annually, and changes are implemented on the third Friday in September, using market data from the end of July as the basis for the review process. Changes in the composition of the Index are made to ensure that the Index includes those companies that, within the eligible countries and within each industry sector, have the greatest market capitalization. The Index is also reviewed on an on-going basis, and changes in the composition of the Index may be necessary if there have been extraordinary events for one of the issuers of the underlying securities, e.g., delisting, bankruptcy, merger or takeover. In these cases, the event is taken into account as soon as it is effective. The underlying securities may be changed at any time for any reason. Neither STOXX nor any of its founders is affiliated with Morgan Stanley and neither has participated in any way in the creation of the Notes.<sup>17</sup>

In calculating the Index, STOXX uses a divisor, currently equal to 512.863106, which represents the Index Aggregate Market Capitalization on the base date and which can be adjusted to allow changes in the issues share capital of individual underlying securities, including the

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<sup>16</sup> This figure represents the average of the average number of shares of each Index component traded for the past 30 trading days. It is calculated by taking the sum of the volumes of the individual Index components for the past 30 trading days, dividing it by the total number of components (50), and then dividing the result by 30.

<sup>17</sup> Telephone conversation between Alex Kogan, Associate General Counsel, Amex, to Florence Harmon, Senior Special Counsel, Division, Commission, dated October 6, 2004.



deletion and addition of stocks, the substitution of stocks, stock dividends and stock splits, to be made without distorting the Index.<sup>18</sup>

Nasdaq represents that NASD's surveillance procedures are adequate to properly monitor the trading of the Notes. Specifically, NASD will rely on its current surveillance procedures governing equity securities and will include additional monitoring on key pricing dates.

If manipulative activity or other types of trading activity that raise regulatory concerns are suspected and involve Index component stocks, then, in order to obtain the needed information, the NASD will rely on the Intermarket Surveillance Group ("ISG") Agreement, to which the NASD and some of the Index component markets are parties, on the Memoranda of Understanding and similar arrangements ("MOUs") between the Commission (or the United States) and the relevant foreign regulators or countries (the ISG Agreement and the MOUs are referred to collectively as "Surveillance Information Sharing Arrangements"), and on information available domestically with respect to those issuers that list sponsored ADRs in the United States. At present, in excess of 90% of the capitalization of the Index is subject to the Surveillance Information Sharing Arrangements.<sup>19</sup>

Nasdaq will contact Commission staff regarding continued listing of the Notes if: (i) the home countries of the component securities representing more than 50% of the capitalization of the Index are not subject to Surveillance Information Sharing Arrangements with the NASD; (ii)

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<sup>18</sup> Telephone conference between Alex Kogan, Associate General Counsel, Nasdaq, and Florence Harmon, Senior Special Counsel, Division, dated October 4, 2004.

<sup>19</sup> Nasdaq represents that there is only one foreign stock exchange, HEX Helsinki, currently represented in the Index that is not subject either to the ISG Agreement with the NASD or to an MOU with the Commission. There is one Index stock that is currently listed on that exchange. This stock, Nokia, represents approximately 4 percent of the weight of the Index, and has a sponsored ADR listed on the NYSE. Telephone conference between Alex Kogan, Associate General Counsel, Nasdaq, and Florence Harmon, Senior Special Counsel, Division, dated October 5, 2004.

a home country of the component securities representing more than 20% of the capitalization of the Index is not subject to Surveillance Information Sharing Arrangements; and (iii) two home countries of component securities representing more than 33 1/3% of the capitalization of the Index are not subject to the Surveillance Information Sharing Arrangements with the NASD.<sup>20</sup>

Since the Notes will be deemed equity securities for the purpose of NASD Rule 4420(f), the NASD and Nasdaq's existing equity trading rules will apply to the Notes. Pursuant to NASD Rule 2310 and IM-2310-2, members must have reasonable grounds for believing that a recommendation to a customer regarding the purchase, sale or exchange of any security is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.<sup>21</sup> In addition, as previously described, Nasdaq will distribute a circular to members providing guidance regarding compliance responsibilities and requirements, including suitability recommendations, and highlighting the special risks and characteristics of the Notes. Furthermore, the Notes will be subject to the equity margin rules. Lastly, the regular equity trading hours of 9:30 am to 4:00 pm will apply to transactions in the Notes.

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<sup>20</sup> Cf. Securities Exchange Act Release No. 34-46021 (June 3, 2002), 67 FR 39753 (June 10, 2002) (approving the listing and trading of notes based on the Select European 50 Index with similar statement regarding surveillance obligations).

<sup>21</sup> Prior to the execution of a transaction in the Notes that has been recommended to a non-institutional customer, NASD Rule 2310(b) requires a member to make reasonable efforts to obtain information concerning a customer's financial status, a customer's tax status, the customer's investment objectives, and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Pursuant to Rule 10A-3 of the Act<sup>22</sup> and Section 3 of the Sarbanes-Oxley Act of 2002,<sup>23</sup> Nasdaq will prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements set forth therein.

Morgan Stanley will deliver a prospectus in connection with the initial purchase of the Notes. The procedure for the delivery of a prospectus will be the same as Morgan Stanley's current procedure involving primary offerings.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,<sup>24</sup> in general, and with Section 15A(b)(6) of the Act,<sup>25</sup> in particular, in that the proposal 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. Specifically, the proposed rule change will provide investors with another investment vehicle based on the Index.

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

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

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

Written comments were neither solicited nor received.

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<sup>22</sup> 17 CFR 240.10A-3.

<sup>23</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002).

<sup>24</sup> 15 U.S.C. 78o-3.

<sup>25</sup> 15 U.S.C. 78o-3(6).

#### IV. Solicitation of Comments

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

##### 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-138 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-NASD-2004-138. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without

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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-NASD-2004-138 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

Nasdaq requests that the Commission approve this filing on an accelerated basis since it raises no new or novel issues and will enable Nasdaq to accommodate the timetable of listing the Notes. In this regard, Nasdaq notes, and the Commission concurs, that the Commission has previously approved the listing of options on, and/or securities the based on the Index.<sup>26</sup> The Commission has also previously approved the listing of securities with a structure that is the same or substantially the same as that of the Notes.

After careful consideration, the Commission finds that the proposed rule change, is consistent with the requirements of the Act and the rules and regulations thereunder, applicable to a national securities association, and, in particular, with the requirements of Section 15A(b)(6) of the Act<sup>27</sup> in that it is designed to promote just and equitable principles of trade, to

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<sup>26</sup> See Securities Exchange Act Release Nos. 49715 (May 17, 2004), 69 FR 29597 (May 24, 2004) (approving listing and trading of 97% Protected Notes Linked to the Performance of the Global Equity Basket, which included the Index); 46021 (June 3, 2002), 67 FR 39753 (June 10, 2002) (approving listing and trading of notes based on the Dow Jones EURO STOXX 50 Return Index, which is based on the Index); and 40303 (August 4, 1998), 63 FR 42892 (August 11, 1998) (approving listing and trading of BRoad InDex Guarded Equity-linked Securities linked to the value of the Index).

<sup>27</sup> 15 U.S.C. 78 o -3(b)(6).

remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.<sup>28</sup> The Commission believes that the Notes will provide investors with a means of participating in the market for foreign securities.

The Notes are a medium-term, senior non-convertible debt securities whose price will be based on the value of the Index. In particular, the Commission believes that the Notes provide investors the opportunity to obtain upside leveraged returns based on the Index subject to a cap that is expected to represent an appreciation of 58.5% to 63% over the original issue price of the Notes. Unlike ordinary debt securities, the Notes do not pay interest or guarantee any return of principal at maturity. If the value of the Index has declined from the time of pricing to the time of maturity, a beneficial owner will receive less, and possibly significantly less, than the original issue price of \$10 per PLUS. The Commission notes that the return of the Notes, if the Index declines, is not leveraged.

At maturity, if the value of the Index has increased, a beneficial owner will be entitled to receive a payment on the Notes based on 300% the amount of that percentage increase, subject to the Maximum Total Payment at Maturity, which is expected to be between \$15.85 and \$16.30 per Note. Any payment that a beneficial owner will be entitled to receive at maturity depends entirely on the relation of the value of the Index and the value of the Index on the day they are priced for initial sale to the public. If the Final Index Value is greater than the Initial Index Value, the payment at maturity per PLUS will equal the lesser of: (a) \$10 plus the Leveraged Upside Payment and (b) the Maximum Payment at Maturity. If the Final Index Value is less

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<sup>28</sup> In approving the proposed rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

than or equal to the Initial Index Value, the payment at maturity per PLUS will equal \$10 times the Index Performance Factor.

Because the Final Index Value on the Notes is derivatively priced and based upon the performance value of the Index, there are several issues regarding the trading of this type of product. For reasons discussed below, the Commission believes that Nasdaq's proposal adequately addresses the concerns raised by this type of product.

First, the Commission notes that the protections of NASD Rule 4420(f) were designed to address the concerns attendant to the trading of hybrid securities like the Notes.<sup>29</sup> In particular, by imposing the hybrid listing standards, suitability for recommendations,<sup>30</sup> and compliance requirements, noted above, the Commission believes that Nasdaq has adequately addressed the potential problems that could arise from the hybrid nature of the Notes. The Commission notes that Nasdaq will distribute a circular to its membership that provides guidance regarding member firm compliance responsibilities and requirements, including suitability recommendations, and highlights the special risks and characteristics associated with the Notes. Specifically, among other things, the circular will indicate that the Notes do not guarantee a total return of principal at maturity, that the upside return on the Notes is expected to be capped between 58.5% to 63% over the original issue price \$10 per PLUS,<sup>31</sup> that the Notes will not pay interest, and that the Notes will provide exposure in the Index. Distribution of the circular should help to ensure that only customers with an understanding of the risks attendant to the trading of the Notes and who

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<sup>29</sup> See 1993 Order, *supra* note 3.

<sup>30</sup> As discussed above, Nasdaq will advise members recommending a transaction in the Notes to: (1) determine that the transaction is suitable for the customer; and (2) have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, the transaction.

are able to bear the financial risks associated with transactions in the Notes will trade the Notes. In addition, the Commission notes that Morgan Stanley will deliver a prospectus in connection with the initial purchase of the Notes.

Second, the Commission notes that the final rate of return on the Notes depends, in part, upon the individual credit of the issuer, Morgan Stanley. To some extent this credit risk is minimized by the NASD's listing standards in NASD Rule 4420(f), which provide that only issuers satisfying substantial asset and equity requirements may issue these types of hybrid securities. In addition, the NASD's hybrid listing standards further require that the Notes have at least \$4 million in market value.

Third, the Notes will be registered under Section 12 of the Act. As noted above, the NASD's and Nasdaq's existing equity trading rules will apply to the Notes, which will be subject to equity margin rules and will trade during the regular equity trading hours of 9:30 a.m. to 4 p.m. NASD Regulation's surveillance procedures for the Notes will be the same as its current surveillance procedures for equity securities and will include additional monitoring on key pricing dates.

Fourth, the Commission has a systemic concern that a broker-dealer, such as Morgan Stanley, or a subsidiary providing a hedge for the issuer will incur position exposure. However, as the Commission has concluded in previous approval orders for the hybrid instruments issued by broker-dealers,<sup>32</sup> the Commission believes that this concern is minimal given the size of the

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<sup>31</sup> The Commission notes that the actual Initial Index Value on the day the Notes are priced for initial sale to the public will be disclosed in the final prospectus supplement.

<sup>32</sup> See Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving File No. SR-NASD-2001-73) (approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Index); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001)



Notes issuance in relation to the net worth of Morgan Stanley.<sup>33</sup>

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the publication of the notice of filing thereof in the Federal Register. The Commission believes the Notes will provide investors with an additional investment choice and the accelerated approval of the proposal and allow investors to begin trading the Notes promptly.

In addition, the Commission notes that it has previously approved the listing of options on, and/or securities the performance of which is based on the Index.<sup>34</sup> The Commission has also previously approved the listing of securities with a structure that is the same or substantially the same as the Notes.<sup>35</sup>

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(order approving File No. SR-Amex-2001-40) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving File No. SR-Amex-96-27) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a weighted portfolio of healthcare/biotechnology industry securities).

<sup>33</sup> The original issue price of the Notes includes commissions (and the secondary market prices are likely to exclude commissions) and Morgan Stanley's costs of hedging its obligations under the Notes. The costs could increase the Initial Value of the Notes, thus affecting the payment investors receive at maturity. The Commission expects such hedging activity to be conducted in accordance with applicable regulatory requirements.

<sup>34</sup> See supra note 11.

<sup>35</sup> See Securities Exchange Act Release Nos. 48677 (October 21, 2003), 68 FR 61524 (October 28, 2003) (approving the listing and trading of Accelerated Return Notes linked to the S&P 500); 47464 (March 7, 2003), 68 FR 12116 (March 13, 2003) (approving the listing and trading of Market Recovery Notes Linked to the S&P 500); 30394 (February 21, 1992), 57 FR 7409 (March 2, 1992) (approving the listing and trading of a unit investment trust linked to the S&P 500); 27382 (October 26, 1989), 54 FR 45834 (October 31, 1989) (approving the listing and trading of Exchange Stock Portfolios based on the value of the S&P 500); 31591 (December 11, 1992), 57 FR 60253 (December 18, 1992) (approving the listing and trading of Portfolio Depositary Receipts based on the S&P 500); and 19907 (June 24, 1983), 48 FR 30814 (July 5, 1983) (approving the listing and trading of options on the S&P 500).

Accordingly, the Commission believes there is good cause, consistent with Sections 15A(b)(6) and 19(b)(2) of the Act,<sup>36</sup> to approve the proposal, on an accelerated basis.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>37</sup> that the proposed rule change (SR-NASD-2004-138) is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>38</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>36</sup> 15 U.S.C. 78o3(b)(6) and 78s(b)(2).

<sup>37</sup> 15 U.S.C. 78s(b)(2).

<sup>38</sup> 17 CFR 200.30-3(a)(12).