

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,¹⁴ and, in particular, with the requirements of section 6(b) of the Act¹⁵ and the rules and regulations thereunder. The Commission finds that the proposed rule change, as amended, is consistent with section 6(b)(5) of the Act,¹⁶ 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 consistent with the Act.

The Commission finds that the trading of options on the Index will permit investors to participate in the price movements of the 600 securities on which the Index is based. The Commission also believes that the trading of options on the Index will allow investors holding positions in some or all of the securities underlying the Index to hedge the risks associated with their portfolios. Accordingly, the Commission believes S&P Small Cap 600 options will provide investors with an important trading and hedging mechanism that should reflect accurately the overall movement of stocks in the small-capitalization range of U.S. equity securities. By broadening the hedging and investment opportunities of investors, the Commission believes that the trading of S&P Small Cap 600 options will serve to protect investors, promote the public interest, and contribute to remove impediments to a free and open market.¹⁷

¹⁴ 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).

¹⁵ 15 U.S.C. 78f(b).

¹⁶ 15 U.S.C. 78f(b)(5).

¹⁷ Pursuant to section 6(b)(5) of the Act, the Commission must predicate approval of any new option or warrant proposal upon a finding that the introduction of such new derivative instrument is in the public interest. Such a finding would be difficult for a derivative instrument that served no hedging or other economic function, because any benefits that might be derived by market participants likely would be outweighed by the potential for manipulation, diminished public confidence in the integrity of the markets, and other valid regulatory concerns. In this regard, the trading of listed options or warrants on the S&P Small Cap 600 Index will provide investors with a hedging vehicle that should reflect the overall movement of

The trading of S&P Small Cap 600 options, however, raises several issues, including issues related to index design, customer protection, surveillance, and market impact. For the reasons discussed below, the Commission believes that the ISE has adequately addressed these issues.

a. Index Design and Structure

The Commission finds that it is appropriate and consistent with the Act to classify the Index as broad-based, and therefore to permit Exchange rules applicable to the trading of broad-based index options to apply to the Index options. Specifically, the Commission believes the Index is broad-based because it reflects a substantial segment of the U.S. equities market, in general, and small-capitalization securities in particular. First, the Index consists of 600 relatively actively traded,¹⁸ small-capitalization domestic securities. Second, the total capitalization of the Index, as of August 21, 2003, was \$397 billion, with the market capitalizations of the individual stocks in the Index ranging from a \$3 billion to \$56 million, with a median value of \$517 million. Third, the Index includes stocks of companies from a broad range of industry sectors, and no industry sector comprises more than 20.2% of the Index's total value. Fourth, as of August 21, 2003, no single stock comprised more than 0.74% of the Index's total value, and the percentage weighting of the 100 largest issues in the Index accounted for only 34.14% of the Index. Fifth, the Commission believes that the Index selection and maintenance criteria will serve to ensure that the Index maintains its broad representative sample of stocks in the small-capitalization range of U.S. equity securities. Accordingly, the Commission believes it is appropriate to classify the Index as broad-based.¹⁹ Should the

the small-capitalization stock universe. The Commission also believes that these options will provide investors with a means by which to make investment decisions in the small-capitalization equity market, allowing them to establish positions or increase existing positions in small-capitalized stocks in a cost effective manner.

¹⁸ A significant majority of the stocks are relatively actively traded, as indicated by an Index component stock median Average Daily Trading Volume of 139,002 shares. See Amendment No. 1, *supra* note 3.

¹⁹ The Commission notes that an index purportedly representing high capitalization stocks might not be deemed to have actively traded stocks if the component stocks' median Average Daily Trading Volume was only 139,002 shares. With regard to a small capitalization index, where almost by their nature the most active stocks will likely not be included, a median average daily trading volume less than that for existing broad based indexes could be acceptable, depending upon the index's other features. For the S&P Small Cap 600, the

character of the Index change from the basic description contained in the rule filing, ISE will so notify the Commission staff. Such a change could require a filing pursuant to section 19(b)(1) of the Act and Rule 19b-4 thereunder.²⁰

The Commission believes that the general broad diversification, capitalizations, and relatively liquid markets of the Index's component stocks significantly minimize the potential for manipulation of the Index. First, as discussed above, the Index represents a broad cross-section of domestic small capitalization stocks, with no single industry group or stock dominating the Index. Second, the majority of the stocks that comprise the Index are relatively actively traded.²¹ Third, the Commission believes that the Index selection and maintenance criteria will serve to ensure that the Index will not be dominated by low-priced stocks with small capitalizations, floats, and trading volumes.²² Fourth, the ISE will monitor the Index semi-annually, and will notify staff of the Commission in the event that (1) ten percent of the capitalization of the Index is comprised of securities with a market capitalization of less than \$100 million; (2) ten percent of the capitalization of the Index is made up of components with an average daily trading volume of less than 10,000 shares over the previous six months; or (3) non-U.S. component securities (common stock or ADRs) that are not subject to a comprehensive surveillance agreement in the aggregate represent more than twenty percent weight of the Index's aggregate market

median average daily trading volume is acceptable given the large number of component stocks and the inclusion of criteria designed to exclude inactively traded stocks from being selected. See Amendment No. 1, *supra* note 3.

²⁰ See Amendment No. 1, *supra* note 3.

²¹ See *supra* note 18.

²² Currently, 61% of the Index is accounted for by stocks meeting the ISE's options listing standards. These standards, which are uniform among the options exchanges, provide that a security underlying an option must, among other things, meet the following requirements: (1) The public float must be of at least 7 million shares; (2) there must be a minimum of 2,000 stockholders; (3) trading volume must have been at least 2.4 million over the preceding twelve months; and (4) the market price must have been at least \$3.00 for the previous five consecutive business days if the security is a "covered security," as defined under section 18(b)(1)(A) of the Securities Act of 1933, or \$7.50 for a majority of the business days during the preceding three calendar months if the security is not a "covered security." See ISE Rule 502.

As a general matter, for broad-based index options, the Commission prefers that at least 50% of an index's components continue to be options-eligible. Given the broad diversity of the Small Cap 600 Index and the selection and maintenance criteria, together with the fact that 61% of the Index's components are options eligible, the Commission believes that the Index will not be readily susceptible to manipulation.