

that ETFs may be: (1) Based on a portfolio of fixed income securities; (2) issued in return for a deposit of a specified portfolio of fixed income securities and/or cash; and (3) redeemed at a holder's request by the investment company, which will pay the redeeming holder fixed income securities and/or cash.⁷

Upon approval of the proposed amendments to PCXE Rule 5.2(j)(3), the Exchange also proposes to trade, on a UTP basis, the following four series of the iShares Trust, a registered open-end management investment company (the "Trust"): iShares 1–3 Year Treasury Index Fund, iShares 7–10 Year Treasury Index Fund, iShares 20+ Year Treasury Index Fund, and iShares GS \$ InvesTop™ Corporate Bond Fund (each, a "Fund," and jointly, the "Funds").

Each Fund will hold certain fixed income securities selected to correspond generally to the price and yield performance of a specified U.S. Treasury, Government/Credit, or Corporate Bond Index (each, an "Underlying Index") maintained either by Lehman Brothers, or, for the Goldman Sachs Corporate Bond Fund, by Goldman Sachs & Co. Barclays Global Fund Advisors ("Advisor") is the investment advisor to each Fund. The Advisor is registered under the 1940 Act. The Advisor is a wholly owned subsidiary of Barclays Global Investors, N.A., which, in turn, is a wholly owned indirect subsidiary of Barclays Bank PLC of the United Kingdom. SEI Investments Distribution Co. ("Distributor"), a Pennsylvania corporation and broker-dealer registered under the Exchange Act, is the principal underwriter and distributor of Creation Unit Aggregations (as defined below) of iShares. The Distributor is not affiliated with the Exchange or the Advisor.

A. Operation of the Funds

Each Fund is designed to provide investment results that correspond generally to the price and yield performance of its Underlying Index. In seeking to achieve its respective investment objective, each Fund will utilize "passive" indexing investment strategies. Each Fund may fully replicate its Underlying Index, but currently intends to use a "representative sampling" strategy to track its Underlying Index. A Fund utilizing a representative sampling strategy generally will hold a basket of the component securities ("Component Securities") of its Underlying Index, but it may not hold all of the Component Securities of its Underlying Index (as

compared to a Fund that uses a replication strategy which invests in substantially all of the Component Securities in its Underlying Index in the same approximate proportions as in the Underlying Index).⁸

When using a representative sampling strategy, the Advisor attempts to match the risk and return characteristics of a Fund's portfolio to the risk and return characteristics of the Underlying Index. As part of this process, the Advisor subdivides each Underlying Index into smaller, more homogenous pieces. These subdivisions are sometimes referred to as "cells." A cell will contain securities with similar characteristics. For fixed income indices, the Advisor generally divides the index according to the five parameters that determine a bond's risk and expected return: duration, sector, credit rating, coupon and the presence of embedded options. When completed, all bonds in the index will have been assigned a cell. The Advisor then begins to construct the portfolio by selecting representative bonds from these cells. The representative sample of bonds chosen from each cell is designed closely to correlate to the duration, sector, credit rating, coupon and embedded option characteristics of each cell. The characteristics of each cell when combined are, in turn, designed to closely correlate to the duration, sector, credit rating, coupon and embedded option characteristics of the Underlying Index as a whole. The Advisor may exclude less liquid bonds in order to create a more tradable portfolio and improve arbitrage opportunities.⁹

According to the Application, the representative sampling techniques used by the Advisor to manage fixed

income funds do not materially differ from the representative sampling techniques it uses to manage equity funds. Due to the differences between bonds and equities, the Advisor analyzes different information (e.g., coupon rates instead of dividend payments).

According to the Application, the Funds' use of the representative sampling strategy is beneficial for a number of reasons. First, the Advisor can avoid bonds that are "expensive names" (i.e., bonds that trade at perceived higher prices or lower yields because they are in short supply) but have the same essential risk, value, duration and other characteristics as less expensive names. Second, the use of representative sampling techniques permits the Advisor to exclude bonds that it believes will soon be deleted from the Underlying Index. Third, the Advisor can avoid holding bonds it deems less liquid than other bonds with similar characteristics. Fourth, the Advisor can develop a basket that is easier to construct and cheaper to trade, thereby potentially improving arbitrage opportunities. From time to time, adjustments may be made in the portfolio of each Fund in accordance with changes in the composition of the Underlying Index or to maintain compliance with requirements applicable to a regulated investment company ("RIC") under the Internal Revenue Code. For example, if at the end of a calendar quarter a Fund would not comply with the RIC diversification tests, the Advisor would make adjustments to the portfolio to ensure continued RIC status. The Exchange notes, however, that Applicants do not anticipate that the Funds would need to make such adjustments, particularly since these Funds (other than the iShares Lehman Corporate Bond Fund and the iShares GS \$ InvesTop™ Corporate Bond Fund) invest a very large percentage of their assets in U.S. Treasury securities.

The Exchange represents that the Advisor expects that each Fund will have a tracking error relative to the performance of its respective Underlying Index of no more than five percent (5%). Each Fund's investment objectives, policies and investment strategies will be fully disclosed in its prospectus ("Prospectus") and statement of additional information ("SAI"). At least 90% of each of the iShares 1–3 Year Treasury Index Fund, iShares 7–10 Year Treasury Index Fund, and iShares 20+ Year Treasury Index Fund's assets will be invested in Component Securities of its respective Underlying Index. Each of these Funds

⁸ The Commission approved an "Application" by the Trust, the Advisor and the Distributor ("Applicants") for an Order under Sections 6(c) and 17(b) of the 1940 Act for the purpose of exempting the Funds from various provisions of the 1940 Act. See Investment Company Act Release No. 25622 (June 24, 2002) (approving File No. 812-12390). See also *supra* note 6.

⁹ As stated in the Application, the Goldman Sachs Index excludes bonds with embedded options. Although the Lehman Indices may include bonds with embedded options, the bonds in each Lehman Index (and the respective Deposit Securities and Fund Securities, as defined herein) should be liquid and easily tradable because each Lehman Index consists of U.S. Treasury and agency securities and/or liquid corporate and non-corporate bonds. To the extent a particular bond is less liquid than another bond with similar characteristics, the Advisor's representative sampling techniques should permit the Advisor to replace the less liquid bond with a more liquid one. For these reasons, the Applicants do not believe the presence of bonds with embedded options in an Underlying Index, the Deposit Securities or Fund Securities would have any material impact on the creation/redemption process and the efficiency of the arbitrage mechanism for each Fund.

⁷ See *supra*, note 4.