

trading of the Notes that are linked to the Index should not unduly impact the market for the underlying securities comprising the Index or raise manipulative concerns.²¹ As discussed more fully above, the underlying stocks comprising the Index are well-capitalized, highly liquid stocks. Moreover, the issuers of the underlying securities comprising the Index are subject to reporting requirements under the Act, and all of the component stocks are either listed or traded on, or traded through the facilities of, U.S. securities markets. Additionally, the Amex's surveillance procedures will serve to deter as well as detect any potential manipulation.

Furthermore, the Commission notes that the Notes are depending upon the individual credit of the issuer, Morgan Stanley. To some extent this credit risk is minimized by the Exchange's listing standards in Section 107A of the Company Guide which provide the only issuers satisfying substantial asset and equity requirements may issue securities such as the Notes. In addition, the Exchange's "Other Securities" listing standards further require that the Notes have a market value of at least \$4 million.²² In any event, financial information regarding Morgan Stanley in addition to the information on the 500 common stocks comprising the Index will be publicly available.²³

The Commission also has a systemic concern, however, 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 other hybrid instruments issued by broker-dealers,²⁴ the Commission believes that

this concern is minimal given the size of the Notes issuance in relation to the net worth of Morgan Stanley.

Finally, the Commission notes that the value of the Index will be disseminated at least once every fifteen seconds throughout the trading day. The Commission believes that providing access to the value of the Index at least once every fifteen seconds throughout the trading day is extremely important and will provide benefits to investors in the product.

The Commission finds good cause for approving the proposed rule change, as amended, prior to the 30th day after the date of publication of the notice of filing thereof in the **Federal Register**. The Exchange has requested accelerated approval because this product is similar to several other instruments currently listed and traded on the Amex.²⁵ The Commission believes that the Notes will provide investors with an additional investment choice and that accelerated approval of the proposal will allow investors to begin trading the Notes promptly. Additionally, the Notes will be listed pursuant to Amex's existing hybrid security listing standards as described above. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,²⁶ to approve the proposal on an accelerated basis.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,²⁷ that the proposed rule change (SR-Amex-2004-48) and Amendment No. 1 thereto is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50016; File No. SR-Amex-2004-43]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by the American Stock Exchange LLC Relating to the Listing and Trading of Notes Linked to the Performance of the Nikkei 225 Index

July 14, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 3, 2004, the American Stock Exchange LLC ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. 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 Substance of the Proposed Rule Change

The Exchange proposes to list and trade notes linked to the performance of the Nikkei 225 ("Nikkei 225" or "Index"). The text of the proposed rule change is available at the Office of the Secretary, the Amex and at the Commission.

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 Amex 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 Amex 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 the Statutory Basis for, the Proposed Rule Change

1. Purpose

Under Section 107A of the Amex Company Guide ("Company Guide"), the Exchange may approve for listing

²¹ The issuer Morgan Stanley disclosed in the prospectus that 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. These 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.

²² See Company Guide Section 107A.

²³ The Commission notes that the 500 component stocks that comprise the Index are reporting companies under the Act, and the Notes will be registered under Section 12 of the Act.

²⁴ See Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving the listing and trading of notes whose return is based on the performance of the Nasdaq-100 Index) (File No. SR-NASD-2001-73); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving the listing and trading of notes whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index) (File No. SR-Amex-2001-40); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving the listing and trading of

notes whose return is based on a weighted portfolio of healthcare/biotechnology industry securities) (File No. SR-Amex-96-27).

²⁵ See *supra* note 18.

²⁶ 15 U.S.C. 78f(b)(5) and 78s(b)(2).

²⁷ 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

²⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

and trading securities which cannot be readily categorized under the listing criteria for common and preferred stocks, bonds, debentures, or warrants.³ The Amex proposes to list for trading under Section 107A of the Company Guide notes linked to the performance of the Nikkei 225 (the "Nikkei Notes" or "Notes").⁴ Morgan Stanley will issue the Notes under the name "PLUSSM." The Nikkei 225 is determined, calculated and maintained solely by NKS.⁵ The Notes will provide an uncapped multiplier in the positive performance of the Nikkei 225 during their term. The Notes will not be subject to a maximum payment amount or ceiling.

The Nikkei 225 Notes will conform to the initial listing guidelines under Section 107A⁶ and continued listing guidelines under Sections 1001–1003⁷ of the Company Guide. The Notes are senior non-convertible debt securities of Morgan Stanley. The Notes will have a term of not less than one year but no more than ten (10) years and are expected to mature on June 30, 2009. Morgan Stanley will issue the Notes in

denominations of whole units (a "Unit"), with each Unit representing a single Note. The original public offering price will be \$10 per Unit. The Notes will entitle the owner at maturity to receive an amount based upon the percentage change of the Nikkei 225. The Notes will not have a minimum principal amount that will be repaid, and accordingly, payment on the Notes prior to or at maturity may be less than the original issue price of the Notes.⁸ The Notes are also not callable by the issuer, Morgan Stanley, or redeemable by the holder.

The payment that a holder or investor of a Note will be entitled to receive (the "Redemption Amount") will depend on the relation of the level of the Nikkei 225 at the close of the market on the second trading day⁹ prior to maturity of the Notes (the "Final Level") and the closing value of the Index on the trading day immediately following the day the Notes are priced for initial sale to the public (the "Initial Value"). At maturity, if the Final Level is greater than the Initial Value, the investor will receive for each \$10 principal amount of PLUS

that he holds, a payment equal to \$10 plus the percentage increase in the value of the Nikkei 225 Index multiplied by the "Upside Leverage Factor," which is expected to be 170–180% of the Initial Value. If the Final Value is equal to the Initial Value, the investor will receive a payment of \$10 equal to the principal amount invested for each PLUS. If the Final Value declines from the Initial Value, the investor will receive proportionally less at maturity than the \$10 principal invested. Thus, the Notes are not principal protected because the payment at maturity is linked to the performance of the Nikkei 225 Index. If there is a "market disruption event"¹⁰ when determining the Final Level of the Index, the Final Level will be determined on the next available trading day during which no "market disruption event" occurs.

Thus, if the percentage change of the Index is positive (*i.e.*, Final Level is greater than the Initial Level), the Redemption Amount per Unit will equal:

$$\$10 + \left[\$10 \times \left(\frac{\text{Final Level} - \text{Initial Level}}{\text{Initial Level}} \right) \times \text{Upside Leverage Factor} \right]$$

³ See Securities Exchange Act Release No. 27753 (March 1, 1990), 55 FR 8626 (March 8, 1990) (order approving File No. SR-Amex-89-29).

⁴ Morgan Stanley and Nihon Keizai Shimbun, Inc. ("NKS") have entered into a non-exclusive license agreement providing for the use of the Nikkei 225 by Morgan Stanley and certain affiliates and subsidiaries in connection with certain securities including these Notes. NKS is not responsible and will not participate in the issuance and creation of the Notes.

⁵ The Nikkei 225 is calculated, published and disseminated by NKS. The Notes are not sponsored, endorsed, sold or promoted by NKS. NKS is a recognized service with business information in Japan and publishes a large business daily, The Nihon Keizai Shimbun, and four other financial newspapers. NKS is not affiliated with a securities broker or dealer. The Index measures the composite price performance of selected Japanese stocks. The Index is currently based on the 225 Underlying Stocks trading on the Tokyo Stock Exchange ("TSE") and represents a broad cross-section of Japanese industry. All 225 of the stocks underlying the index are stocks listed in the First Section of the TSE. Stocks listed in the First Section are among the most actively traded stocks on the TSE. The Index is a modified, price-weighted index. Each component stock's weight in the Index is based on its price per share rather than the total market capitalization of the issuers. NKS calculates the Index by multiplying the per share price of a component stock by the corresponding weighting factor for the stock (a "Weight Factor"), calculating the sum of all these products and dividing that sum by a divisor. The divisor, initially set on May 16, 1949 at 225, was 23.156 as of June 1, 2004, and is subject to periodic adjustments. Each Weight Factor is computed by dividing ¥50 by the par value of the relevant component stock, so that the share price

of each component stock when multiplied by its Weight Factor corresponds to a share price based on a uniform par value of ¥50. Each Weight Factor represents the number of shares of the related component stock, which are included in one trading unit of the Index. The stock prices used in the calculation of the Index are those reported by a primary market for the component stocks, which is currently the TSE.

⁶ The initial listing standards for the Notes require: (1) a minimum public distribution of one million units; (2) a minimum of 400 shareholders; (3) a market value of at least \$4 million; and (4) a term of at least one year. In addition, the listing guidelines provide that the issuer has assets in excess of \$100 million, stockholder's equity of at least \$10 million, and pre-tax income of at least \$750,000 in the last fiscal year or in two of the three prior fiscal years. In the case of an issuer which is unable to satisfy the earning criteria stated in Section 101 of the Company Guide, the Exchange will require the issuer to have the following: (1) assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (2) assets in excess of \$100 million and stockholders' equity of at least \$20 million.

⁷ The Exchange's continued listing guidelines are set forth in Sections 1001 through 1003 of Part 10 to the Exchange's Company Guide. Section 1002(b) of the Company Guide states that the Exchange will consider removing from listing any security where, in the opinion of the Exchange, it appears that the extent of public distribution or aggregate market value has become so reduced to make further dealings on the Exchange inadvisable. With respect to continued listing guidelines for distribution of the Notes, the Exchange will rely, in part, on the guidelines for bonds in Section 1003(b)(iv). Section 1003(b)(iv)(A) provides that the Exchange will normally consider suspending dealings in, or

removing from the list, a security if the aggregate market value or the principal amount of bonds publicly held is less than \$400,000.

⁸ A negative return of the Nikkei 225 will reduce the redemption amount at maturity with the potential that the holder of the Note could lose his entire investment amount.

⁹ A "trading day" is generally a day on which trading is conducted on the TSE and on any exchange on which futures or options related to the Index are traded, other than a day on which trading on any such exchange is scheduled to close prior to its regular final weekday closing time.

¹⁰ A "market disruption event" is defined as (i) the occurrence of a suspension, absence, or material limitation of trading of 20% or more of the component stocks of the Index on the primary market for more than two hours of trading or during the one-half hour period preceding the close of the principal trading session on such primary market; (ii) a breakdown or failure in the price and trade reporting systems of any primary market as a result of which the reported trading prices for 20% or more of the component stocks of the Index during the last one-half hour preceding the close of the principal trading session on such primary market are materially inaccurate; (iii) the suspension, material limitation, or absence of trading on any major securities market for trading in futures or options contracts or exchange traded funds related to the Index for more than two hours of trading or during the one-half hour period preceding the close of the principal trading session on such market; and (iv) a determination by Morgan Stanley & Co., Incorporated that any event described in clauses (i)–(iii) above materially interfered with the ability of Morgan Stanley or any of its affiliates to unwind or adjust all or a material portion of the hedge position with respect to the Notes.

The Upside Leverage Factor, determined at the time of issuance, is expected to be between 170–180%.

If the percentage change of the Index is zero or negative (*i.e.*, Final Level is less than or equal to the Initial Level), the Redemption Amount per Unit will equal:

$$\$10 \times \left(\frac{\text{Final Level}}{\text{Initial Level}} \right)$$

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 Nikkei 225. The Notes are designed for investors who want to participate in and gain enhanced upside exposure to a broad representation of the Japanese stock market and who are willing to forego principal protection and market interest payments on the Notes during such term. The Securities and Exchange Commission ("Commission" or "SEC") has previously approved the listing of securities linked in whole, or in part, to the performance of the Nikkei 225 on the Exchange.¹¹

As of June 1, 2004, the market capitalization of the securities included in the Nikkei 225 ranged from a high of approximately 14.512 trillion yen (\$131.118 billion) to a low of approximately 31.331 billion yen (\$283.082 million). The average daily trading volume for these same securities for the last six (6) months ranged from a high of approximately 5.996 million shares to a low of approximately 1.190 million shares. The Index is composed of 225 securities and is broad-based. The highest weighted stock has a weight of 3.483% while the top five (5) stocks in the Index account for 14.283%. The level or value of the Index is calculated once per minute during TSE Trading hours¹² and is readily accessible to U.S.

investors at <http://www.nni.nikkei.co.jp> and <http://www.bloomberg.com>. NKS is under no obligation to continue the calculation and dissemination of the Index. In the event that NKS ever ceases to maintain the Index, the Exchange will contact the Commission staff to consider prohibiting the continued trading of the Notes.¹³

In order to maintain continuity in the level of the Index in the event of certain changes due to non-market factors affecting the Underlying Stocks, such as the addition or deletion of stocks, substitution of stocks, stock dividends, stock splits or distributions of assets to stockholders, the divisor used in calculating the Index is adjusted in a manner designed to prevent any instantaneous change or discontinuity in the level of the Index. The divisor remains at the new value until a further adjustment is necessary as the result of another change. As a result of each change affecting any Underlying Stock, the divisor is adjusted in such a way that the sum of all share prices immediately after the change multiplied by the applicable Weight Factor and divided by the new divisor, *i.e.*, the level of the Index immediately after the change, will equal the level of the Index immediately prior to the change.¹⁴

Because the Notes are issued in \$10 denominations, the Amex's existing equity floor trading rules will apply to the trading of the Notes. First, pursuant to Amex Rule 411, the Exchange will impose a duty of due diligence on its members and member firms to learn the essential facts relating to every customer

prior to trading the Notes.¹⁵ Second, the Notes will be subject to the equity margin rules of the Exchange.¹⁶ Third, the Exchange will, prior to trading the Notes, distribute a circular to the membership providing guidance with regard to member firm compliance responsibilities (including suitability recommendations) when handling transactions in the Notes and highlighting the special risks and characteristics of the Notes. With respect to suitability recommendations and risks, the Exchange will require members, member organizations and employees thereof recommending a transaction in the Notes: (1) To determine that such transaction is suitable for the customer, and (2) to 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. In addition, Morgan Stanley will deliver a prospectus in connection with initial sales of the Notes in accordance with its standard prospectus delivery procedures.

The Exchange represents that its surveillance procedures are adequate to properly monitor the trading of the Notes. Specifically, the Amex will rely on its existing surveillance procedures governing equities that include additional monitoring on key pricing dates,¹⁷ which have been deemed adequate under the Act. In addition, the Exchange has an effective surveillance sharing agreement with the TSE that may be used as a basis for listing and trading securities linked to the Nikkei 225.¹⁸ The Exchange also notes that the TSE is a member of the Intermarket Surveillance Group ("ISG").¹⁹ As a result, the Exchange asserts that market surveillance information is available from the TSE, if necessary, due to regulatory concerns that may arise in connection with the component stocks. In the event that it becomes necessary, the Exchange will seek the Commission's assistance pursuant to

¹³ Telephone conversation between Jeffrey Burns, Associate General Counsel, Amex, and Florence Harmon, Senior Special Counsel, Division, Commission, dated July 12, 2004.

¹⁴ Telephone conversation between Jeffrey Burns, Associate General Counsel, Amex, and Florence Harmon, Senior Special Counsel, Division, Commission, dated July 12, 2004 (pertaining to discussion of the continuity of the level of the Index). Underlying Stocks may be deleted or added by NKS. However, to maintain continuity in the Index, the policy of NKS is generally not to alter the composition of the Underlying Stocks except when an Underlying Stock is deleted in accordance with the following criteria. Any stock becoming ineligible for listing in the First Section of the TSE due to any of the following reasons will be deleted from the Underlying Stocks: bankruptcy of the issuer; merger of the issuer into, or acquisition of the issuer by, another company; delisting of the stock or transfer of the stock to the "Seiri-Post" because of excess debt of the issuer or because of any other reason; or transfer of the stock to the Second Section of the TSE. Upon deletion of a stock from the Index, NKS will select, in accordance with certain criteria established by it, a replacement for the deleted Underlying Stock. In an exceptional case, a newly listed stock in the First Section of the TSE that is recognized by NKS to be representative of a market may be added to the Underlying Stocks. As a result, an existing Underlying Stock with low trading volume and not representative of a market will be deleted.

¹¹ See Securities Exchange Act Release Nos. 49670 (May 7, 2004), 69 FR 27959 (May 17, 2004) (approving the listing and trading of Accelerated Return Notes linked to the Nikkei 225); 38940 (August 15, 1997), 62 FR 44735 (August 22, 1997) (approving the listing and trading of notes based on the Major 11 International Index); 34821 (October 11, 1994), 59 FR 52568 (October 18, 1994) (approving the listing and trading of warrants on the Nikkei 300); and 27565 (December 22, 1989), 55 FR 376 (January 4, 1990) (approving the listing and trading of warrants based on the Nikkei 225).

¹² TSE Trading hours are currently 9:00 a.m. to 11:00 a.m. and from 12:30 p.m. to 3:00 p.m. Tokyo time, Monday through Friday. Due to time zone differences, on any normal trading day the TSE will close prior to the opening of business in New York City on the same calendar day. Therefore, the closing level of the Index on a trading day will generally be available in the U.S. by the opening of business on the same calendar day.

¹⁵ Amex Rule 411 requires that every member, member firm or member corporation use due diligence to learn the essential facts, relative to every customer and to every order or account accepted.

¹⁶ See Amex Rule 462 and Section 107B of the Company Guide.

¹⁷ Telephone conversation between Jeffrey Burns, Associate General Counsel, Amex, and Florence Harmon, Senior Special Counsel, Division, Commission, dated July 12, 2004 (pertaining to key pricing dates).

¹⁸ See Information Sharing Agreement between the Amex and the TSE dated September 25, 1990.

¹⁹ ISG membership obligates an exchange to compile and transmit market surveillance information and resolve in good faith any disagreements regarding requests for information or responses thereto.

memoranda of understanding or similar inter-governmental agreements or arrangements that may exist between the Commission and the Japanese securities regulators.

The Exchange also has a general policy that prohibits the distribution of material, non-public information by its employees.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6 of the Act²⁰ in general and furthers the objectives of Section 6(b)(5)²¹ in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

The Exchange does not believe that the proposed rule change will impose 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

The Exchange did not solicit or receive any written comments on the proposed rule change.

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:

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-Amex-2004-43 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-Amex-2004-43. 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 offices of Amex. 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-Amex-2004-43 and should be submitted on or before August 11, 2004.

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

Amex has asked the Commission to approve the proposal on an accelerated basis to accommodate the timetable for listing the Notes. The Commission notes that it has previously approved the listing of securities the performance of which have been linked to, or based on, the Index.²² The Commission has also previously approved the listing of securities with a structure similar to that of the Notes.²³

²² See Securities Exchange Act Release Nos. 49999 (July 9, 2004) (approving the listing and trading of Contingent Principal Protection Notes Linked to the Performance of the Nikkei 225 Index); 49670 (May 7, 2004), 69 FR 27959 (May 17, 2004) (approving the listing and trading of Accelerated Return Notes linked to the Nikkei 225 for Nasdaq); and 38940 (August 15, 1997), 62 FR 44735 (August 22, 1997) (approving the listing and trading of Market Index Target-Term Securities the return on which is based on changes in the value of a portfolio of 11 foreign indexes, including the Nikkei 225 Index).

²³ See Securities Exchange Act Release Nos. 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 Index); 47009 (December 16, 2002), 67 FR 78540 (December 24, 2002) (approving the listing and trading of

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, and, in particular, with the requirements of Section 6(b)(5) of the Act,²⁴ in that it is 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, to protect investors and the public interest.²⁵ The Commission believes that the Notes will provide investors with a means to participate in any percentage increase in the Index that exists at the maturity of the Notes.

The Notes are non-principal protected debt instruments, the price of which will be derived from and based upon the value of the Nikkei 225 Index. The Notes do not have a minimum principal amount that will be repaid at maturity, and the payments of the Notes prior to or at maturity may be less than the original issue price of the Notes. Accordingly, the level of risk involved in the purchase or sale of the Notes is similar to the risk involved in the purchase or sale of traditional common stock. Because the final rate of return of the Notes is derivatively priced, based on the performance of the 225 common stocks underlying the Nikkei 225 Index, and because the Notes are instruments that do not guarantee a return of principal, there are several issues regarding the trading of this type of product. However, for the reasons discussed below, the Commission believes that Amex's proposal adequately addresses the concerns raised by this type of product.

The Commission notes that the protections of Amex Rule 107A were designed to address the concerns attendant to the trading hybrid securities like the Notes. In particular, by imposing the hybrid listing standards, suitability, disclosure, and compliance requirements noted above, the Commission believes that Amex has addressed adequately the potential problems that could arise from the hybrid nature of the Notes. The Commission notes that Amex will distribute a circular to its membership calling attention to the specific risks

Market Recovery Notes linked to the Nasdaq-100 Index); and 46883 (November 21, 2002), 67 FR 71216 (November 29, 2002) (approving the listing and trading of Market Recovery Notes linked to the Dow Jones Industrial Average).

²⁴ 15 U.S.C. 78f(b)(5).

²⁵ 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).

²⁰ 15 U.S.C. 78f.

²¹ 15 U.S.C. 78f(b)(5).

associated with the Notes. The Commission also notes that Morgan Stanley will deliver a prospectus in connection with the initial sales of the Notes. In addition, the Commission notes that Amex will incorporate and rely upon its existing surveillance procedures governing equities, which have been deemed adequate under the Act.

In approving the product, the Commission recognizes that the Index is a stock index calculated, published and disseminated by NKS, which measures the composite price performance of selected Japanese stocks. The Index is currently based on 225 common stocks traded on the TSE and represents a broad cross-section of Japanese industry. All 225 underlying stocks are listed in the First Section of the TSE and are, therefore, among the most actively traded stocks on the TSE. The Nikkei is a modified, price-weighted index, which means a component stock's weight in the Nikkei is based on its price per share rather than total market capitalization of the issuers. NKS calculates the Index by multiplying the per share price of a component stock by the corresponding weighting factor for the stock, calculating the sum of all these products, and dividing that sum by a divisor.

As stated above, NKS is under no obligation to continue the calculation and dissemination of the Index. In the event the calculation and dissemination every minute of the Index is discontinued, Amex represents that it will contact Commission staff and consider prohibiting the continued listing of the Notes. The Commission notes that the changes in the composition of the Nikkei 225 Index is made solely by NKS. The changes to these common stocks tend to be made infrequently with most substitutions the result of mergers and other extraordinary corporate actions. As of June 1, 2004, the market capitalization of the securities included in the Nikkei 225 ranged from a high of approximately 14.512 trillion yen (\$131.118 billion) to a low of approximately 31.331 billion yen (\$283.082 million). The average daily trading volume for these same securities for the last six (6) months ranged from a high of approximately 5.996 million shares to a low of approximately 1.190 million shares. The Index is composed of 225 securities and is broad-based. The highest weighted stock has a weight of 3.483% while the top five (5) stocks in the Index account for 14.283%. Given the composition of the stocks underlying the Nikkei 225 Index, the Commission believes that the listing and

trading of the Notes that are linked to the Nikkei 225 Index should not unduly impact the market for the underlying securities comprising the Nikkei 225 Index or raise manipulative concerns.²⁶ As discussed more fully above, the underlying stocks comprising the Nikkei 225 Index are well-capitalized, highly liquid stocks.

In light of the fact that the Nikkei is a foreign index, the Commission believes adequate surveillance sharing agreements between the Amex and the TSE is a necessary prerequisite to deter and detect potential manipulations or other improper or illegal trading involving the Notes. While many of the issuers of the underlying securities comprising the Nikkei 225 are not subject to reporting requirements under the Act, Amex represents that an adequate surveillance sharing agreement exists through the ISG between the Amex and the TSE to deter and detect potential manipulations or other improper trading in the underlying components. Therefore, Amex's surveillance procedures will serve to deter as well as detect any potential manipulation. This agreement obligates the Amex and TSE to compile and transmit market surveillance information and resolve in good faith any disagreements regarding requests for information. Accordingly, the Commission believes that the surveillance sharing Agreement through ISG is adequate for the Amex to surveil the components of the Nikkei 225 for potential manipulation or other trading abuses between the markets with respect to the trading of the Notes based on the Nikkei 225.

Furthermore, the Commission notes that the Notes are dependent upon the individual credit of the issuer, Morgan Stanley. To some extent this credit risk is minimized by the Amex's listing standards in Amex Rule 107A, which provide the only issuers satisfying substantial asset and equity requirements may issue securities such as the Notes. In addition, the Amex's hybrid listing standards further require that the Notes have a market value of at least \$4 million. In any event, financial information regarding Morgan Stanley, in addition to the information on the 225 common stocks comprising the

Nikkei 225 Index, including the dissemination of the Index value once per minute, will be publicly available.²⁷

The Commission also has a systemic concern, however, 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 other hybrid instruments issued by broker-dealers,²⁸ the Commission believes that this concern is minimal given the size of the Notes issuance in relation to the net worth of Morgan Stanley.

Finally, as the Commission noted, the value of the Nikkei 225 Index will be disseminated at least once every minute throughout the trading day. Because the Nikkei 225 Index contains foreign securities and is composed of highly liquid and well-capitalized securities, the Commission believes that providing access to the value of the Index at least once every minute throughout the trading day is sufficient and will provide benefits to investors in the product.

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that the Notes will provide investors with an additional investment choice and that accelerated approval of the proposal will allow investors to begin trading the Notes promptly. In addition, the Commission notes that it has previously approved the listing and trading of other derivative securities based on the Index and securities with a structure similar to that of the Notes.²⁹ Accordingly, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b)(2) of the Act,³⁰ to approve the proposal, on an accelerated basis.

²⁷ See <http://www.nni.nikkei.co.jp> and <http://www.bloomberg.com>.

²⁸ See, e.g., Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving the listing and trading of notes whose return is based on the performance of the Nasdaq-100 Index) (File No. SR-NASD-2001-73); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving the listing and trading of notes whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index) (File No. SR-Amex-2001-40); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving the listing and trading of notes whose return is based on a weighted portfolio of healthcare/biotechnology industry securities) (File No. SR-Amex-96-27).

²⁹ See *supra* notes 22 and 23.

³⁰ 15 U.S.C. 78f(b)(5) and 78s(b)(2).

²⁶ The issuer Morgan Stanley disclosed in the prospectus that 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. These 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.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,³¹ that the proposed rule change (SR-Amex-2004-43) is hereby approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.³²

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50028; File No. SR-CBOE-2004-16]

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to a Proposed Rule Change and Amendment No. 1 Thereto Relating to an Interpretation of Paragraph (b) of Article Fifth of Its Certificate of Incorporation and an Amendment to Rule 3.16(b)

July 15, 2004.

I. Introduction

On March 4, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt an interpretation, embodied in an agreement dated December 17, 2003 ("2003 Agreement"), between the CBOE and the Board of Trade of the City of Chicago, Inc. ("CBOT"), of paragraph (b) of Article Fifth of the CBOE Certificate of Incorporation ("Article Fifth(b)") and CBOE Rule 3.16, pertaining to the right of the 1,402 Full Members of CBOT to become members of CBOE without having to purchase a CBOE membership ("Exercise Right"). On April 9, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.³ The proposed rule change, as amended, was published for comment in the **Federal Register** on May 3, 2004.⁴ The Commission received

one comment letter on the proposed rule change.⁵ On May 25, 2004, the CBOE submitted a response to the comment letter,⁶ and the commenter replied to CBOE's response in a second comment letter submitted on June 16, 2004.⁷ This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

The CBOE is proposing to interpret Article Fifth(b) to explain how it will apply, upon the distribution by the CBOT to each of its 1,402 Full Members upon their individual request, to a separately transferable interest representing the Exercise Right component of each CBOT Full Membership. According to the CBOE, the CBOT's willingness to issue transferable Exercise Right interests is reflected in the 2003 Agreement. Because CBOE Rule 3.16 currently refers to certain terms that were previously interpreted and defined in an agreement between CBOE and the CBOT in 1992 ("1992 Agreement"), and the terms are now further interpreted and defined in the 2003 Agreement, the proposed rule change also amends CBOE Rule 3.16 to add a reference in the 2003 Agreement.

The 2003 Agreement contemplates the issuance by the CBOT of a separately transferable interest representing the Exercise Right component of a CBOT Full Membership in advance of the consummation of the CBOT's proposed corporate restructuring, which contemplates a similar separately transferable interest structure.⁸ In addition, the CBOE represents that the CBOT's membership has approved changes to the CBOT Rules and Regulations, pursuant to the terms of the

2003 Agreement, to give effect to a structure providing for the issuance of these interests. Thus, the interpretation, embodied in the 2003 Agreement, constitutes the substance of the proposed rule change.

The interpretation of Article Fifth(b), embodied in the 2003 Agreement, includes definitions of who will be "Eligible CBOT Full Members" and "Eligible CBOT Full Member Delegates" entitled to exercise after the CBOT has issued separately transferable interests representing the Exercise Right component of CBOT Full Memberships to those CBOT Full Members who request them. The interests are referred to in the 2003 Agreement and in this filing as "Exercise Right Privileges."

The CBOE represents that, under these definitions, to become a member of the CBOE by virtue of the Exercise Right, the holder or delegate (*i.e.*, a lessee under CBOT Rules and Regulations) of one of the 1,402 outstanding CBOT Full Memberships in which an Exercise Right Privilege has been issued must possess one Exercise Right Privilege, whether bundled or unbundled⁹ from the related CBOT Full Membership. In addition, the CBOE believes that a CBOE exerciser member must also possess all of the other rights or privileges appurtenant to a CBOT Full Membership; meet the applicable membership and eligibility requirements of the CBOT; and be deemed to be a "CBOT Full Member" or a "CBOT Full Member Delegate" under the CBOT Rules and Regulations.

The 2003 Agreement also provides that the CBOT will adopt and maintain rules and procedures acceptable to the CBOE governing the issuance and subsequent transfer of Exercise Right Privileges and CBOT Full Memberships, to enable the CBOE to administer the operation of the Exercise Right in a manner consistent with the interpretation embodied in the 2003 Agreement. In addition, the 2003 Agreement states that the CBOE intends to make an offer to CBOT Full Members that, subject to the terms and conditions of the offer, will allow the CBOE to purchase Exercise Right Privileges from those CBOT Full Members that accept the offer.¹⁰ Further, as provided in the

⁵ Letter from Thomas A. Bond, Member, CBOE, *et al.*, to Jonathan G. Katz, Secretary, Commission, dated April 28, 2004.

⁶ Letter from Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE, to Jonathan G. Katz, Secretary, Commission, dated May 24, 2003.

⁷ Letter from Thomas A. Bond, Member, CBOE, *et al.*, to Jonathan G. Katz, Secretary, Commission, dated June 8, 2004 ("June 8th Letter").

⁸ The CBOE noted that the CBOT's proposed restructuring has not yet been consummated and that it remains uncertain when the proposed restructuring will occur. Indeed, the 2003 Agreement specifically states that the CBOT is not obligated to consummate the contemplated restructuring or any other restructuring. The CBOE also noted that the CBOT's proposal to issue a separately transferable interest representing the Exercise Right as part of its restructuring was the subject of a prior proposed interpretation by the CBOE of Article Fifth(b), which was filed with the Commission as a proposed rule change in File No. SR-CBOE-2002-01. On April 7, 2004, the CBOE withdrew this filing. See letter from Arthur B. Reinstein, Deputy General Counsel, CBOE, to Lisa N. Jones, Special Counsel, Division, Commission, dated April 6, 2004.

³¹ 15 U.S.C. 78s(b)(2).

³² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Arthur B. Reinstein, Deputy General Counsel, CBOE, to Lisa N. Jones, Special Counsel, Division of Market Regulation ("Division"), Commission, dated April 8, 2004 ("Amendment No. 1").

⁴ Securities Exchange Act Release No. 49620 (April 26, 2004), 69 FR 24205.

⁹ According to the CBOE, under the proposed interpretation of Article Fifth(b) embodied in the 2003 Agreement, Exercise Right Privileges may be separately bought and sold and bundled and rebundled with the other rights and privileges of CBOT Full Membership for purposes of making the holder of an Exercise Right Privilege eligible to exercise.

¹⁰ In addition, the 2003 Agreement states that CBOE's offer would have no effect on a CBOT Full Member's right to exercise on the CBOE if the CBOT Full Member chooses not to accept CBOE's offer,