

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51663; File No. SR-ISE-2004-40)

May 6, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1, 2, and 3 Thereto Relating to Procedures for the Allocation of Options on Index-based Products

I. Introduction

On December 14, 2004, the International Securities Exchange, Inc. (“ISE” 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 amend ISE Rule 802 to add criteria for allocating options based on indices and fund shares (“Index-based Products”) to Primary Market Makers and Competitive Market Makers. On January 18, 2005, the ISE filed Amendment No. 1 to the proposed rule change.³ On March 2, 2005, the ISE filed Amendment No. 2 to the proposed rule change.⁴ On March 21, 2005, the ISE filed Amendment No. 3 to the proposed rule change.⁵ The proposed rule change, as amended, was published for comment in the Federal Register on April 5, 2005.⁶ The Commission received no comments on the proposal, as amended. This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Form 19b-4, dated January 18, 2005, which replaced the original filing in its entirety (“Amendment No. 1”).

⁴ See Form 19b-4, dated March 2, 2005, which replaced Amendment No. 1 in its entirety (“Amendment No. 2”).

⁵ See Form 19b-4, dated March 21, 2005, which replaced Amendment No. 2 in its entirety (“Amendment No. 3”).

⁶ See Securities Exchange Act Release No. 51443 (March 29, 2005), 70 FR 17279.

II. Description of the Proposal

The ISE proposes to amend ISE Rule 802 to (a) specify that the ISE's Board or a designated committee of the Board is required to make market maker appointments in the best interest of the Exchange to provide competitive markets, and (b) add criteria for allocating Index-based Products to Primary Market Makers and Competitive Market Makers. Specifically, with respect to the criteria for Index-based Products, the Exchange proposes to require a Primary Market Maker who seeks an allocation of an Index-based Product to provide specific quotation spread and size commitments for the first year of listing. These commitments would remain in effect, unless a change is approved by the ISE Board or a designated committee of the Board upon the request of the Primary Market Maker. In addition, under the proposal, a Primary Market Maker may, but would not be required to, provide commitments regarding marketing or other support with respect to the Index-based Product, including information regarding order flow arrangements with order flow providers. Finally, the ISE represented that the proposed amendments to ISE Rule 802 would apply only to allocation decisions made after the approval of this proposal.

III. Discussion

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 exchange⁷ and, in particular, the requirements of Section 6 of the Act⁸ and the rules and regulations thereunder. Specifically, the Commission finds that the

⁷ In approving this proposed rule change, as amended, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f.

proposal to require that the Board or designated committee make market maker appointments in the best interest of the Exchange and to add criteria for allocating Index-based Products to Primary Market Makers is consistent with Section 6(b)(5) of the Act⁹ because it is designed to promote just and equitable principles of trade and, in general, to protect investors and the public interest. Specifically, the Commission believes that the proposal should assist the Board or designated committee in making allocation decisions.

With regard to order flow commitments that a Primary Market Maker may make, the Commission believes that the ISE should use this information solely to evaluate existing order flow arrangements between the applicant and order flow providers.¹⁰ The Commission notes that ISE represented that it would not use existing order flow commitments as an indicator of potential future order flow that an applicant may be able to bring to the ISE. In addition, the ISE represented that a future change to, or termination of, any order flow arrangements considered by the ISE during the review process would not be used by the ISE at any point in the future to terminate an allocation or to take remedial action against a Primary Market Maker and that the ISE would not

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ The ISE represented that it would use such information solely to evaluate existing order flow arrangements between the applicant and order flow providers and would not use such information as a basis to terminate an allocation or take remedial action against a Primary Market Maker. See supra note 6.

The Commission notes that other exchanges made similar representations regarding their use of order flow commitment information, and the Commission has emphasized that order flow commitments may be used solely to evaluate existing order flow arrangements and may not be used as a basis for termination of an allocation or for taking remedial action against a market maker. See Securities Exchange Act Release Nos. 49577 (Apr. 19, 2004), 69 FR 22576 (Apr. 26, 2004) (approving File No. SR-CBOE-2004-17); and 51126 (Feb. 2, 2005), 70 FR 6915 (Feb. 9, 2005) (approving File No. SR-Phlx-2004-90).

take any remedial action solely because orders subject to any order flow arrangements were not subsequently routed to the Exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹¹ that the proposed rule change (SR-ISE-2004-40), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland
Deputy Secretary

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).