

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53007; File No. SR-ISE-2005-48)

December 22, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Order Granting Approval of a Proposed Rule Change and Amendments No. 1 and 2 Thereto Relating to Market Maker Quote Interaction

I. Introduction

On October 3, 2005, 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 804(d) regarding a delay of up to one second before two market maker quotations interact. On October 21, 2005, the ISE submitted Amendment No. 1 to the proposed rule change.³ On November 3, 2005, the ISE submitted Amendment No. 2 to the proposed rule change.⁴ The proposed rule change and Amendments No. 1 and 2 were published for comment in the Federal Register on November 10, 2005.⁵ The Commission received no comments on the proposal. 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 October 21, 2005, which replaced the original filing in its entirety (“Amendment No. 1”).

⁴ See partial amendment dated November 3, 2005, which corrected a minor omission in the current rule text and a typographical error in the filing (“Amendment No. 2”).

⁵ Securities Exchange Act Release No. 52729 (November 3, 2005), 70 FR 68485 (“Notice”).

II. Description

Currently, ISE Rule 804(d) provides for a one-second delay before the quotations of ISE market makers interact.⁶ As noted in SR-ISE-2004-24, the ISE treats orders and quotations differently, with ISE Rule 804(a) stating that only market makers may enter quotations on the ISE. Market makers use quotations to input and update prices on multiple series of options at the same time. Quotations generally are based on pricing models that rely on various factors, including the price and volatility of the underlying security. The ISE stated that as these variables change, a market maker's pricing model automatically updates quotations for some or all of an option's series. In contrast, an order is an interest to buy a stated number of contracts of one specific options series. The ISE noted that all ISE members, including ISE market makers, can enter orders.⁷

According to the ISE, the purpose of the one-second delay was to allow a market maker to update its quotations to reflect price changes in an underlying stock before another market maker's quotation could "hit" the updating market maker's quotation. In SR-ISE-2004-24, the ISE represented that it promptly processes quotation updates when it receives them, but that there is invariably a lag between the time the underlying stock price first changes and the time by which the ISE can process all the corresponding quotation changes. In SR-ISE-2004-24, the ISE also stated its belief that the one-second delay would allow the ISE the time to process quotation updates, without effecting multiple executions during the update process. In the Notice, the ISE noted, however, that the one-second delay may no longer be necessary as the ISE trading system

⁶ See Securities Exchange Act Release No. 49931 (June 28, 2004), 69 FR 40696 (July 6, 2004) ("SR-ISE-2004-24").

⁷ ISE Rule 717 imposes various limitations on orders that Electronic Access Members may enter on the ISE, while ISE Rule 805 governs market maker orders.

and its market maker members' quoting systems continue to advance technologically. Accordingly, the ISE proposes an amendment to ISE Rule 804(d) to give the ISE the flexibility to remove the one-second delay. In making a determination to remove the one-second delay, the ISE stated that it would take into consideration input from its market maker members, particularly through the ISE's Market Maker Advisory Committee. The ISE also noted that any change made to the one-second delay would be implemented on a uniform, market-wide basis (as opposed to, for example, a class-by-class basis). Further, the ISE stated that it would inform its members of any changes made to the one-second delay by distributing a Regulatory Information Circular prior to the implementation of any such change.

III. Discussion

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 exchange⁸ and, in particular, the requirements of Section 6(b) of the Act⁹ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁰ in that it designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest.

In SR-ISE-2004-24, the Commission noted the ISE's belief that, without the proposed one-second "timer" function, pricing inefficiencies would result on the Exchange, and ISE

⁸ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

market makers would widen their quotations or limit size to avoid multiple executions against other market makers.¹¹ To the extent the ISE trading system and its market maker members' quoting systems continue to advance technologically to reduce the likelihood of market maker quotes interacting, the one-second delay may no longer be necessary. Accordingly, the Commission believes that granting the ISE the flexibility to remove the one-second delay in such circumstance is consistent with the Act. Additionally, the Commission believes that permitting the ISE to determine to reinstate the one-second delay also is consistent with the Act, if the reinstatement of the delay is necessary to avoid the interaction of market maker quotations. In determining whether to remove the one-second delay, the Commission understands that the ISE would consult with its market maker members, particularly through the Exchange's Market Maker Advisory Committee. Regardless of whether the ISE makes any changes to the one-second delay, the Commission notes that ISE market makers would be required to be firm for their quotations for the same size to customers and broker-dealer orders, including orders for the account of other ISE market makers.

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In connection with the approval of SR-ISE-2004-24, the Commission granted ISE's request for a limited exemption from Rule 602 of Regulation NMS under the Act ("Quote Rule"). Specifically, the Commission granted ISE market makers an exemption from their obligations under paragraph (c)(2) of the Quote Rule with respect to trades with matching ISE market maker quotations for no more than one second, provided that the quotations are locked or crossed for no more than one second, and that such ISE market maker is firm to all other customer and broker-dealer orders, including orders for the accounts of other ISE market makers. See letter from Robert Colby, Deputy Director, Division of Market Regulation, Commission, to Michael Simon, Senior Vice President and General Counsel, ISE, dated June 24, 2004.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (SR-ISE-2005-48), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Jonathan G. Katz
Secretary

¹² 15 U.S.C. 78f(b)(2).

¹³ 17 CFR 200.30-3(a)(12).